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90-672

Supreme Court, U.S.
FILED
OCT 22 1990
JOSEPH F. SPANIOL, JR.
CLERK

CASE NO.

in the Supreme Court of the United States

October Term, 1990

GARY PLASTIC PACKAGING CORPORATION,
a New York corporation,
for itself and all others similarly situated,

Petitioner,

vs.

MERRILL, LYNCH, PIERCE, FENNER & SMITH, INC.,
a Delaware corporation, et al.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND JUDICIAL CIRCUIT

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Question Presented for Review

WHERE THE PREDOMINATING ISSUE IN A SECURITIES FRAUD CASE IS FRAUDULENT OMISSION OF MATERIAL FACTS BETWEEN THE SECURITIES FIRM AND ITS OWN ACCOUNT EXECUTIVES, WHETHER A PARTIAL DEFENSE ON THE MERITS AS TO DAMAGES RENDERS THE ONLY PROPOSED CLASS REPRESENTATIVE IN AN OTHERWISE TIME-BARRED SECURITIES CLASS ACTION SO INADEQUATE AS TO DEFEAT CLASS CERTIFICATION.

List of Parties

Plaintiff/Petitioner:

Gary Plastic Packaging Corporation, a New York corporation[1], for itself and all others similarly situated

Defendants/Respondents:

Merrill Lynch, Pierce, Fenner & Smith, Inc., a Delaware corporation

Merrill Lynch Money Markets, Inc., a Delaware corporation

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[1]In compliance with S.Ct.R. 29.1, Gary Plastic Packaging Corporation states that it has no parent or subsidiary corporations.

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Opinions Below

The opinion of the Court of Appeals is reported: *Gary Plastic Packaging Corporation v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 903 F.2d 176 (2d Cir. 1990). The opinion of the district court is reported: *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 119 F.R.D. 344 (S.D.N.Y. 1988). The prior opinion of the Court of Appeals is also reported: *Gary Plastic Packaging Corporation v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985). All opinions are included in the appendix to this Petition.

Statement of Grounds for Jurisdiction

The United States Court of Appeals for the Second Circuit entered the judgment sought to be reviewed on May 14, 1990, and denied a petition for rehearing and a suggestion for rehearing *en banc* on July 24, 1990. This Court has jurisdiction pursuant to 28 U.S.C. §1254(1) (1982).

Statutes Involved

Plaintiff sued under Section 5 of the Securities Act of 1933, 15 U.S.C. §77e, Section 12(2) of the Securities Act of 1933, 15 U.S.C. §77q, Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. §78j and Rule 10b-5 thereunder. Plaintiff also alleges violation of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §1962(c) (1982). The issue before this Court is governed by Rule 23, Fed.R.Civ.P.

Statement of the Case

Gary Plastic Packaging Corporation, a New York corporation ("Gary Plastic"), for itself and all others similarly situated, Plaintiff below, petitions this Court to issue a writ of certiorari quashing the decision of the Second Circuit Court of Appeals, which affirmed the district court's finding that the proposed plaintiff class should not be certified, in a securities class action brought under Section 5 of the Securities Act of 1933, Section 12(2) of the Securities Act of 1933 and Section 10 of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The court of appeals declined to overturn the district court's decision that the plaintiff class did not meet the typicality and adequacy of representation provisions of Rule 23, Fed.R.Civ.P., because of allegedly unique defenses on the merits thought to be applicable only to Gary Plastic.

Statement of the Facts

1. The Defendants' Conduct

In 1980, Merrill Lynch Money Markets, Inc. ("Money Markets") initiated a program which enabled investors to purchase insured $100,000 certificates of deposit ("CD's") issued by banks around the country. Money Markets and Merrill Lynch, Pierce, Fenner & Smith, Inc. ("Merrill Lynch") marketed the CD's in accordance with the terms of an internal bulletin that was distributed to Merrill Lynch retail brokers. *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith,* 756 F.2d 230, 233-236 (2d Cir. 1985).

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The Bulletin was intended for use by account executives; it was not a sales brochure.[2] Merrill Lynch used it to train its account executives to market the CD's.[3]

The Bulletin omitted several material facts and was misleading. It omitted the fact that Merrill Lynch's selected financial institutions offered their CD's at a higher rate, for the same maturity and face amount, directly to any purchasers.[4] It failed to disclose that Merrill Lynch was acting on behalf of the financial institutions rather than on behalf of the customer in setting the rates. 756 F.2d at 235, 242.[5]

The Bulletin contained no disclosure of the method by which Merrill Lynch arrived at the CD rates, and it omitted to state that Money Markets arbitrarily set the CD rates based on some formula Merrill Lynch itself devised. 756 F.2d at 233-235. Put another way, the Bulletin omitted to state that Merrill Lynch required the financial institutions to create

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[2]*See* excerpts from deposition of D. Cacciapaglia, App. 68-69.

[3]*See* excerpts from deposition of H. Schur, App. 73-74.

[4]For example, as shown by Gary Plastic in the district court, Pacific Federal offered 15% interest to customers who purchased CD's directly from it, as compared to the 13.8% interest rate paid Gary Plastic on the CD it bought through Merrill Lynch. Similarly, State Savings Stockton was offering 16.1% interest to direct buyers of its CD's, while Gary Plastic received only 14.5% on its State Savings Stockton CD purchased through Merrill Lynch. 756 F.2d at 235.

[5]In fact, Money Markets would not even inquire at what rate the institution were selling CD's directly to customers on each day. *See* excerpts from deposition of E. Falzon, App. 70-72.

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unique jumbo CD's at rates lower than the institutions were willing to pay.

The Bulletin failed to reveal the formula for determining the amount of commission derived by Money Markets on the sale of each CD. *Id.*[6] The Bulletin omitted any explanation of the price, in terms of interest points sacrificed, which a Merrill Lynch customer had to pay in order to obtain the attributes of "marketability" and "liquidity" which were the selling points of a Merrill Lynch CD. *Id.*

This information Bulletin, with its significant omissions, formed the basis for any oral representation by a Merrill Lynch broker to a Merrill Lynch customer. *Id.*; *see also Gary Plastic Packaging Corporation v. Merrill Lynch, Pierce, Fenner & Smith,* 119 F.R.D. 344, 345-346 (S.D.N.Y. 1988).

2. The Class Representative

Gary Plastic, the proposed class plaintiff, is a going concern employing approximately 450 persons in 1985, with sales of $15 to 17 million for fiscal year 1984.[7]

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[6]*See also* excerpts from deposition of E. Falzon at App. 70-72.

[7]Gary Plastic is a closely-held corporation. Its four shareholders are Gary Hellinger, his wife Marilyn Schur Hellinger, and her brothers, Kenneth Schur and Robert Schur. Gary Hellinger is Gary Plastic's president. Robert Schur is its general counsel, vice-president and assistant secretary. Robert Schur is of counsel to the Miami law firm of Bailey & Hunt. 903 F.2d at 176-177.

Between May and July, 1982, Gary Plastic purchased 12 short-term CD's through Merrill Lynch. In July, 1982, Robert Schur also purchased a short-term CD through Merrill Lynch for his own account. Howard Schur was the Merrill Lynch account executive for all of these transactions.[8] 903 F.2d at 177.

In late July, 1982, Gary Plastic's president, Gary Hellinger, discovered that the CD's which Gary Plastic had bought through Merrill Lynch paid lower interest than CD's which could have been purchased directly from the issuing banks. *Id.* After discovering these facts, Gary Plastic bought some CD's directly from the issuing banks.

Unknown to Gary Plastic's president, however, in August and October, 1982, Gary Plastic's bookkeeper "rolled over" a total of four CD's that Gary Plastic had bought from Merrill Lynch. Gary Hellinger, Gary Plastic's president, testified that he was not aware of the rollovers until receiving a records subpoena in this proceeding. *Id.*; 119 F.R.D. at 355.[9]

Procedural History

In 1983, Gary Plastic filed this suit as a class action against Merrill Lynch and Money Markets in the Southern District of Florida, alleging securities fraud. Gary Plastic timely moved for class certification on November 10, 1983. The district court never acted on

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[8]Since approximately 1973, Howard Schur, a cousin of Marilyn, Kenneth, and Robert Schur, had been the stockbroker for Gary Plastic and various members of the Schur family.

[9]*See* excerpts from deposition of Gary Hellinger, App. 62-67.

this motion; instead, in December, 1983, it transferred the action to the Southern District of New York, pursuant to 28 U.S.C. §1404(a). That district court (Brieant, J.) entered summary judgment for defendants on May 18, 1984. Determining that the CD program constituted a security and that Gary Plastic's proposed amended complaint set forth triable claims, the Second Circuit reversed and remanded. *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 232-243 (2d Cir. 1985).

Gary Plastic served its amended complaint; it again moved for class certification on July 19, 1985. On February 10, 1988, the district court (Haight, J.) denied certification. The district court held that Gary Plastic was an inappropriate class representative, that its claim was subject to unique defenses, including Gary Plastic's rollover of CD's purchased through Merrill Lynch, and Petitioner's family relationship with the Merrill Lynch broker who sold the CD's to Gary Plastic.

Applying New York Bar rules to Gary Plastic's Florida counsel, the district court also disqualified Gary Plastic's counsel, Bailey & Hunt, from pursuing Gary Plastic's individual claims because of a perceived conflict created by Robert Schur's "of counsel" relationship to Bailey & Hunt.

Subsequently, when Gary Plastic's local New York counsel failed to appear at a scheduled (but not noticed) pre-hearing conference, another conference was scheduled in June, 1988. At that time, Gary Plastic's local counsel sought leave to withdraw. Florida counsel moved to reargue the certification and disqualification issues. But the district court rejected as

untimely the motion to reargue, allowed local counsel to withdraw, and dismissed Gary Plastic's individual claims with prejudice.[10]

On September 23, 1988, the district court entered final judgment dismissing Gary Plastic's individual claims with prejudice. *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 119 F.R.D. 344 (S.D.N.Y. 1988).

On appeal, the Second Circuit affirmed, holding that refusal to certify the claim was not an abuse of the district court's discretion.[11] Judgment was entered on May 14, 1990. *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 903 F.2d 176 (2d Cir. 1990). Gary Plastic's petition for rehearing and suggestion for rehearing *en banc* was denied and judgment entered on July 24, 1990. [App. 51-52]

Reasons for Allowing the Writ

In the decision below, the highly regarded Second Circuit has lent its influential voice to a body of case law contradicting this Court's landmark decision in

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[10]Ignoring Gary Plastic's stated inability to obtain other counsel, the district court directed the clerk to stay the entry of the order of dismissal to allow Gary Plastic 30 days to move to vacate the dismissal. Gary Plastic noticed its appeal immediately upon the expiration of the 30-day period; that appeal was dismissed by stipulation pending the entry of a judgment of dismissal in the district court.

[11]The Second Circuit did not decide the issue whether the district court erred in disqualifying Bailey & Hunt as counsel for Gary Plastic's individual claims.

Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974), and ignoring the plain meaning of Rule 23, Fed.R.Civ.P.

The Second Circuit's opinion that Gary Plastic is not an adequate class representative denies any possibility of relief to thousands of potential class members whose claims are now time-barred. It undermines this Court's authority in an important body of case law and is likewise in conflict with earlier decisions of the Second Circuit itself, and other circuits, which would direct class certification on these facts. *See* Sup.Ct.R. 10.1(a) and (c).

In evaluating whether class certification was appropriate under Rule 23, the Second Circuit cited *Green v. Wolf Corp.*, 406 F.2d 291, 295, 298 (2d Cir. 1968), *cert. denied*, 395 U.S. 977 (1969), for the proposition that all factors affecting certification are to be construed liberally "in light of the importance of the class action device in securities fraud suits." 903 F.2d at 179.

Then, in an action directly contradicting its own precedent in *Green*, and this Court's opinion in *Eisen*, the Second Circuit narrowly construed case law to conclude that an alleged "unique defense" on the merits bars Gary Plastic from representation of the class of defrauded Merrill Lynch investors that it seeks to represent.

Decisions of this Court as well as leading cases in the Third, Tenth, and Eleventh Circuits favor granting class certification in all but the most unusual circumstances to protect absent class members. *See Eisen, supra; In Re School Asbestos Litigation*, 789

F.2d 996 (3d Cir.), *cert. denied*, 479 U.S. 852, 915 (1986); *Esplin v. Hirschi*, 402 F.2d 94, 99 (10th Cir.), *cert. denied*, 394 U.S. 928 (1968).

The Eleventh Circuit, Petitioner's original choice of forum, has favored class certification despite the existence of factual variances in class plaintiff's circumstances which are analogous to the so-called "unique defenses" in the instant case. *See Kirkpatrick v. J.C. Bradford & Co.*, 827 F.2d 718, 728 (11th Cir. 1987), *cert. denied*, 485 U.S. 959 (1988); *Cox v. American Cast Iron Pipe Co.*, 784 F.2d 1546, 1557 (11th Cir.), *cert. denied*, 479 U.S. 883 (1986); *Kennedy v. Tallant*, 710 F.2d 711 (11th Cir. 1983); *Haitian Refugee Center, Inc. v. Nelson*, 694 F.Supp. 864 (S.D. Fla. 1988), *aff'd*, 872 F.2d 1555 (11th Cir. 1989).

The prevailing body of law holds that, when considering whether to grant certification of class action status, the court should err in favor of allowing the class action. *Esplin v. Hirschi*, 402 F.2d 94, 101 (10th Cir. 1968); *Green v. Wolf Corp.*, *supra*. The bias in favor of class actions is particularly strong where, as here, no other class representative has stepped forward to represent the class, and denial of class action status would, because of the time bar, terminate prosecution of these securities fraud claims. *King v. Kansas City Southern Industries, Inc.*, 519 F.2d 20, 26 (7th Cir. 1975).

The Second Circuit's decision conflicts with prevailing precedent in at least three other circuits, with this Court's decision, and with its own precedent in *Green v. Wolf*. It should therefore be overturned.

ARGUMENT

GARY PLASTIC MEETS THE RULE 23 REQUIREMENTS FOR CERTIFICATION OF THE CLASS

I. GARY PLASTIC'S CLAIMS ARE TYPICAL OF THE CLASS.

The Second Circuit's stated reasoning for affirming the district court's decision is that Gary Plastic does not meet the requirements of typicality and adequacy of representation required by Fed.R.Civ.P. 23(a)(3) and (4). The court related this to the possibility that unique defenses thought applicable to Gary Plastic might become the focus of the litigation. Said the court:

> Regardless of whether the issue is framed in terms of the typicality of the representative's claims, Rule 23(a)(3), Fed.R.Civ.P., or the adequacy of its representation, Rule 23(a)(4), Fed.R.Civ.P., there is a danger that absent class members will suffer if their representative is preoccupied with defenses unique to it.

903 F.2d at 180.

This concern is palpably unfounded. Petitioner has already prevailed on the overriding, predominate issues (the existence of a security, and the triability of the predominating fraudulent omission claims). Gary Plastic's claim is typical of potential class members' claims. The amended complaint alleges that Merrill Lynch violated federal securities laws through material

omissions and non-disclosures in its sale of CD's to a large group of investors. In this very controversy, the Second Circuit has already determined this CD program to be a security, and held the alleged nondisclosures actionable. 756 F.2d at 242.

As set forth in 3 H. Newberg, *Class Actions* §3.13 (1985):

> Typicality determines whether a sufficient relationship exists between the injury to the named plaintiff and the conduct affecting the class, so that the court may properly attribute a collective nature to the challenged conduct. . . . Thus, a plaintiff's claim is typical if it arises from the same event or practice or course of conduct that gives rise to the claims of other class members, and if his or her claims are based on the same legal theory. [citations omitted]

The Newberg test, based upon this Court's decision in *General Telephone Co. v. Falcon*, 457 U.S. 147 (1982), and the Tenth Circuit's decision in *Penn v. San Juan Hospital, Inc.*, 528 F.2d 1181 (10th Cir. 1975), does not require exact identity of circumstances between the class plaintiff and all class members. As the Tenth Circuit stated in *Penn*:

> It is to be recognized that there may be varying fact situations among individual members of the class and this is all right so long as the claims of the plaintiffs and the other class members *are based on the same legal or remedial theory.*

528 F.2d 1181 at 1189 [emphasis added]. *Accord Gonzales v. Cassidy*, 474 F.2d 67, 71 (5th Cir. 1973) (class plaintiffs' claims are typical if their interests do not conflict with those of the class, and if class plaintiffs' claims for relief are based on the same "legal or remedial theory" as the claims of the class).

In securities class actions specifically, the typicality requirement is met "when the named plaintiff and class members have sustained monetary damages from the defendant's conduct and seek to recover damages for losses resulting from misrepresentations and omissions which affect all class members." H. Newberg, *supra*, §22.11 at p. 28. Gary Plastic meets these tests.

All persons who bought the CD's relied upon Merrill Lynch's representations, skill, and expertise. All class members suffered identical monetary damage: receiving interest rates on their Merrill Lynch CD's that were lower than rates simultaneously available to investors purchasing CD's directly from the banks issuing the CD's for Merrill Lynch. Common to all class members are the omissions in the Bulletin that Merrill Lynch distributed to its own account executives concerning the CD's. There exists a "common nucleus of operative facts" applicable to all class members sufficient for a determination of typicality and adequacy of representation. *Esplin v. Hirschi*, 402 F.2d 94, 99 (10th Cir. 1968).[12]

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[12]These standards are consistent with the explanation by the Advisory Committee to the 1966 revisions of Rule 23, in which the Committee instructed courts to focus on whether the defendant's

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II. THERE IS NO "UNIQUE DEFENSE" SUFFICIENT TO JUSTIFY DENIAL OF CLASS CERTIFICATION

As the Third Circuit reasoned in *Eisenberg v. Gagnon*, 766 F.2d 770, 786 (3d Cir. 1985), *cert. denied*, 474 U.S. 946 (1985), " 'Typical' is not identical. . .":

> [T]he presence of individual questions as to the reliance of each investor does not mean that the common questions of law and fact do not predominate over questions affecting individual members as required by Rule 23(b)(3) or that the representatives' claims are not typical.

In this case, both the Second Circuit and the district court based their decisions in part on the apparent belief that Gary Plastic's ability to represent the class is somehow tainted by the involvement of a "family member" (Howard Schur, a Merrill Lynch account executive) in Gary Plastic's CD purchase from Merrill Lynch, and by Gary Plastic's bookkeeper's inadvertent rollover of Merrill Lynch CD's after

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(Footnote continued from previous page)
fraudulent activity was common to the class, not whether the circumstances of all the plaintiffs were the same:

> [A] fraud perpetrated on numerous persons by the use of similar misrepresentations may be an appealing situation for a class action, and it may remain so despite the need, if liability is found, for separate determination of the damages suffered by individuals within the class.

39 F.R.D. 69, 103 (1966).

discovery of the fraud. Notwithstanding the dubious propriety of disregarding Gary Plastic's incorporated status and assuming that New York legal entities have blood relations, Gary Plastic respectfully submits that these factors do not destroy Gary Plastic's typicality.

The alleged "unique defenses" cited by the court below are simply individual fact questions which may relate to damages, and in any event do not predominate. In view of the hundreds of millions of dollars invested in Merrill Lynch's CD program because of Merrill Lynch's fraudulent scheme, Gary Plastic's putative difficulty in establishing $200 or $300 of its damages can hardly be predicted to be a "focus" or a "preoccupation" deterring Gary Plastic's prosecution of the case. Moreover, these individual facts are negligible compared to Merrill Lynch's overriding scheme to conceal from an entire, large class of investors (including Gary Plastic), and from Merrill Lynch's own account executives (including Howard Schur), the fact that higher interest rates on its $100,000 CD's could be obtained by customers directly from the originating banks.

Even had Gary Plastic relied specifically on Howard Schur's advice, this would not create a unique defense sufficient to defeat typicality. *See Kronfeld v. Trans World Airlines, Inc.*, 104 F.R.D. 50, 53 (S.D.N.Y. 1984) ("Reliance on third parties such as investment counselors or knowledgeable family members is likely to be typical, rather than atypical, of the circumstances under which a substantial number of class members purchased their stock"); *Umbriac v. American Snacks, Inc.*, 388 F.Supp. 265, 273 (E.D.Pa. 1975) (family relationship no bar to class representation); *National*

Superspuds, Inc. v. New York Mercantile Exchange, 77 F.R.D. 361, 371 (S.D.N.Y. 1977) (class certified even though some plaintiffs were members of defendant New York Mercantile Exchange).[13]

In Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 368-369, *reh. denied*, 384 U.S. 915 (1966), this Court directed certification of a class in a similar securities fraud action in which the plaintiff relied solely on her son-in-law's advice in her stock purchases. It was the son-in-law, in fact, who uncovered the fraudulent scheme and had his lawyer prepare a letter for Mrs. Surowitz to sign protesting the alleged fraudulent behavior. The son-in-law's lawyer, a friend, filed the class action complaint. This Court found no conflict or unique defense on these facts, stating:

> The basic purpose of the Federal Rules is to administer justice through fair trials. . . . If rules of procedure work as they should in an honest and fair judicial system, they not only permit, but should as nearly as possible guarantee that bona fide complaints be carried to an adjudication on the merits. Rule 23(b), like the other civil rules, was written to further, not defeat the ends of justice.

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[13] "Typicality" is not destroyed by mere factual variations among the putative class members. Only when the named plaintiff's individual circumstances are "markedly different" or the legal theory advanced by the named plaintiff is different from that relied upon by other members of the class should certification be denied. *See Weiss v. York Hospital*, 745 F.2d 786, 809 n. 36 (3d Cir. 1984), *cert. denied*, 470 U.S. 1060 (1985); *Eisenberg v. Gagnon, supra*, 766 F.2d at 786.

383 U.S. at 372-373. This Court held that Mrs. Surowitz was an adequate class representative despite the family ties inherent in her claim.

In *Kennedy v. Tallant*, 710 F.2d 711 (11th Cir. 1983), the Eleventh Circuit rejected a similar challenge to the named plaintiff's ability to represent the class in a securities fraud action. In *Kennedy*, however, the facts were even more divergent, raising varying issues of reliance and damages. The named plaintiff admitted "never reading the PLC prospectuses and . . . not [relying] on them when purchasing PLC stock." *Id.* at 717. The Eleventh Circuit flatly rejected the defense argument that the named plaintiff's claim was atypical, since he had not read or relied on the prospectuses, while other class members *had* read and relied on them. Directing certification of the class, the Eleventh Circuit said:

> Kennedy's claim is not an individual, separate grievance. His amended complaint alleged that appellants entered into an unlawful conspiracy to defraud Georgia citizens through PLC stock offerings . . . . In other words, Kennedy claimed . . . *that appellants committed the same unlawful acts in the same method against an entire class.*

Id. [emphasis added].[14]

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[14]*Accord Grasty v. Amalgamated Clothing & Textile Workers Union*, 828 F.2d 123 (3d Cir. 1987), *cert. denied*, 484 U.S. 1042 (1988) (where named plaintiffs did not share all the claims of class, but various claims stemmed from a single course of conduct of

(Footnote continued on next page)

The same result is called for here. The fact remains that Gary Plastic made its initial purchases of Merrill Lynch CD's in complete ignorance of the fraud, just like other class members. As such, Gary Plastic is a "typical" class representative. Any question as to Gary Plastic's knowing purchase of CD's after discovering a portion of the fraud is a fact issue relating only to damages, not to reliance or other issues on the merits. The allegedly unique defenses against Gary Plastic are in reality only individual fact questions subsumed by common fraud. Gary Plastic meets the typicality requirements of Rule 23(a)(3).

III. GARY PLASTIC MEETS THE ADEQUACY REQUIREMENTS OF RULE 23(a)(4)

This Court held in *Sosna v. Iowa*, 419 U.S. 393, 403 (1975), that class representation is adequate if plaintiffs are represented by competent counsel and are without disabling conflicts of interest. *Accord General Telephone Co. v. Falcon, supra*, 457 U.S. at 157; *Senter v. General Motors Corp.*, 532 F.2d 511, 524 (6th Cir. 1976), *cert. denied*, 429 U.S. 870 (1976) ("factual identity between the plaintiff's claims and those of the class he seeks to represent is not necessary"). *See also* H. Newberg, *Class Actions*, §3.23 at p. 201-202.

(Footnote continued from previous page)
defendant, typicality requirement was met); *Donaldson v. Pillsbury Co.*, 554 F.2d 825, 831 (8th Cir.), *cert. denied*, 434 U.S. 856 (1977) (named plaintiff typical even though she entered defendant company's employ at a higher level than most class members; her individual circumstances did not change basic patterns and practices of discrimination common to all class members).

For a conflict to be disabling with respect to adequacy of representation, it must be fundamental, going to the heart of the controversy. *See, e.g.*, H. Newberg, *supra*, §3.26 at pp. 205-206; 7A C. Wright, A. Miller and M. Kane, *Federal Practice and Procedure* §1768 at 327 (2d ed. 1986) ("[O]nly a conflict that goes to the very subject matter of the litigation will defeat a party's claim of representative status").[15]

Speculative conflicts must be disregarded at the class certification stage. *See Chisholm v. United States Postal Service*, 665 F.2d 482, 493 n. 12 (4th Cir. 1981) (award of promotion and front pay to class representative was too hypothetical a reason for finding plaintiff inadequate representative in employment discrimination suit; no conflict where he suffered common discrimination in other bids for promotion); *Shores v. Sklar*, 844 F.2d 1485, 1495 (11th Cir. 1988), *cert. denied*, 110 S.Ct. 843 (1990) (fact that class plaintiff was executor of estate that had bought questioned securities presented no disabling conflict; class certified).

A finding of adequacy is not precluded by potential conflicts that may arise only if the plaintiffs succeed on the merits on common claims of liability. Such conflicts may necessitate subclasses or narrowing of class, but should not prevent certification. *See, e.g., Quintana v. Harris*, 663 F.2d 78 (10th Cir. 1981) (plaintiffs must be

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[15] *See Surowitz v. Hilton Hotels Corp., supra* (fact that class representative spoke very little English and could not read or understand class complaint without assistance did not defeat certification).

offered reasonable opportunity to propose subclasses in lieu of denial of certification).

Here, Gary Plastic is an adequate representative. Gary Plastic's position is neither in conflict with nor antagonistic to the remainder of the class. As shown in the Second Circuit's decision in *Gary Plastic Packaging Corporation v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir. 1985), Merrill Lynch was marketing a security, and failed to disclose the truth about the security. Merrill Lynch claimed to obtain the best rates for "jumbo CD's" nationwide. But in fact Merrill Lynch was ordering its participating lenders to set rates *specified by Merrill Lynch* itself—unrelated to and significantly lower than the lenders were actually offering to anyone who walked in their doors.

Merrill Lynch deliberately concealed this scheme from its own employees, who failed to explain this to customers because they did not know it themselves. These material omissions constituted the fraudulent scheme.[16]

Against this background of a common fraudulent scheme, the fact that the cousin of Gary Plastic's president's wife was one of thousands of Merrill Lynch account executives duped by his own company, can

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[16]Where misrepresentation occurs by reason of an omission or failure to disclose by the defendant, reliance is presumed. *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153, *reh. denied*, 407 U.S. 916 and 408 U.S. 931 (1972); *see also Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981) (*en banc*), *cert. denied*, 459 U.S. 1102 (1983); *Rifkin v. Crow*, 574 F.2d 256, 261-62 (5th Cir. 1978).

hardly be thought legally or factually significant. Nor is it significant that Gary Plastic's bookkeeper rolled over the CD's without the knowledge of the principals. These facts simply do not conflict with the legal theory on which Petitioner's suit is based and cannot be found to preclude a finding of "adequacy."

While the foregoing facts may be raised at trial, Defendant's right at trial to defend against classwide proof does not preclude class certification:

> The right of rebuttal . . . does not preclude the predominance of common questions. . . . The fact that a defendant may be able to defeat the showing of causation as to a few individual class members does not transform the common question into a multitude of individual ones.

Blackie v. Barrack, 524 F.2d 891, 907 n. 22 (10th Cir.), *cert. denied*, 429 U.S. 816 (1975).

The mere possibility that Gary Plastic might be unable to receive an award of damages for its unauthorized rollovers cannot justify an otherwise impermissible inquiry into the merits of the case.[17]

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[17]Fact-finding is not the province of the court. As this Court stated in *Tenant v. Peoria & P.U. Ry, Co.*, 321 U.S. 29, 64 S.Ct. 409, 412 (1944), "It is the jury, not the court, which is the fact-finding body. It weighs the contradictory evidence and inferences, judges the credibility of witnesses, receives expert instructions, and draws the ultimate conclusion as to the facts."

To deny class certification on the putative "strength" of an affirmative defense against the proposed class representative is to make an improper preliminary determination on the merits of a claim. In *Eisen v. Carlisle & Jacquelin,* 417 U.S. 156 (1974), rejecting the issue of likelihood of recovery as a factor in deciding whether to certify a class, this Court said:

> We find nothing in either the language or history of Rule 23 that gives a court any authority to conduct a preliminary inquiry into the merits of the suit in order to determine whether it may be maintained as a class action. *** In short, we agree with Judge Wisdom's conclusion in *Milton v. Mackey International,* 452 F.2d 424 (5th Cir. 1971), where the court rejected a preliminary inquiry into the merits of a proposed class action: "In determining the propriety of a class action the question is not whether the plaintiff or plaintiffs have stated a cause of action or will prevail on the merits, but rather whether the requirements of Rule 23 are met." *Id.* at 427.

417 U.S. at 178. Class certification does not depend on a showing of probability of success on the merits. *Id.*; *Huff v. N.D. Cass Co.,* 485 F.2d 710, 712 (5th Cir. 1973) (*en banc*); *Kahn v. Rosenstiel,* 424 F.2d 161, 169 (3d Cir.), *cert. denied,* 398 U.S. 950 (1970), *cited in* H. Newberg, *Class Actions,* §22.16 at pp. 39-40.

The proper course of action is to remand, order certification of the class, and, if necessary, to have the district court designate another representative at a

later time. The trial court should be ordered to use the flexibility provided by Rule 23 to cope with any individual questions of reliance or damages, by creating sub-classes, or by ordering separate trials on the relevant issues.

As aptly stated by the Tenth Circuit in *Esplin v. Hirschi*, 402 F.2d at 99, "If there is to be an error made, let it be in favor and not against the maintenance of the class action, for it is always subject to modification should later developments during the course of the trial so require." *Accord In re School Asbestos Litigation*, 789 F.2d 996, 1011 (3d Cir. 1986), *cert. denied*, 479 U.S. 852 (1986). As this Court stated in *Gen. Tel. Co. of the Southwest v. Falcon*, 457 U.S. 147, 160 (1982), "Even after a certification order is entered, the judge remains free to modify it in the light of subsequent developments in the litigation."

CONCLUSION

Gary Plastic has established that a security exists and has established beyond peradventure the overriding and material non-disclosure inherent in that scheme. All class members suffered the same injury; therefore, conflict or antagonism between Gary Plastic and other members of the class is logically impossible. No other proposed representative has come forward and the statute of limitations has run.

Under such circumstances, the proper course is to remand to the district court, certify the class, and deal with possible conflicts through case management. For the foregoing reasons, Gary Plastic respectfully requests that this Court issue a writ of certiorari to the Second Circuit Court of Appeals and hold that the plaintiff class may be certified.

Respectfully submitted,

Guy B. Bailey, Jr.
Counsel of Record for Petitioner

Appendix

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket 89-7295

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC.

Plaintiff–Appellee,

v.

GARY PLASTIC PACKAGING CORPORATION

Defendants–Appellant.

903 F.2d 176

May 14, 1990

Before: VAN GRAAFEILAND, PIERCE, and PRATT, Circuit Judges.

PIERCE, Senior Circuit Judge:

Gary Plastic Packaging Corp. ("Gary Plastic") appeals from a judgment of the United States District Court for the Southern District of New York, Haight, *Judge,* dismissing its complaint, with prejudice, for failure to prosecute, pursuant to Rule 41(b), Fed.R.Civ.P. On appeal, Gary Plastic seeks review of an order denying its motion for class certification and disqualifying its counsel. *See Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 119 F.R.D. 344 (S.D.N.Y.1988).

I.

While we assume familiarity with both Judge Haight's reported decision and our prior opinion in this case, *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230 (2d Cir.1985), we briefly restate the relevant facts.

Gary Plastic is a closely-held corporation. Its four shareholders are Marilyn Schur Hellinger ("Marilyn"); her husband, Gary Hellinger; and her brothers, Kenneth and Robert Schur. Gary Hellinger is Gary Plastic's president and Robert Schur is its general counsel, vice-president and assistant secretary. Robert Schur is also affiliated with the Miami law firm of Bailey & Dawes (currently, Bailey & Hunt).

Since approximately 1973, Howard Schur, Marilyn's first cousin, has been a stockbroker responsible for accounts for Gary Plastic and various members of the Schur family. From 1978 until 1983, Howard Sc[illegible] was a broker with appellee Merrill Lynch, Pierce, Fe[illegible]er & Smith, Inc. ("Merrill").

In 1980, appellee Merrill Lynch Money Markets, Inc. ("Money Markets") initiated a program which enabled investors to purchase fully-insured $100,000 certificates of deposit ("CDs") issued by banks around the country.

Between May and July 1982, Gary Plastic purchased twelve short-term CDs through Merrill. In July 1982, Robert Schur also purchased a short-term CD through Merrill for his own account. Howard Schur was the broker on all of these transactions.

In late July 1982, Gary Hellinger discovered that the CDs which Gary Plastic had bought through Merrill paid less interest than CDs which could be bought directly from the banks which issued them. Hellinger asked Robert Schur to investigate the situation.

Subsequently, Gary Plastic and Robert Schur each purchased CDs directly from an issuing bank. Gary Plastic, however, continued investing in Merrill's CD program: in August 1982 and in October 1982, it "rolled over" a total of four CDs which it had purchased through Merrill.

In 1983, Gary Plastic retained Bailey & Dawes and filed a complaint asserting claims, on behalf of itself and a class which it sought to represent, against Merrill and Money Markets alleging securities fraud. The action was filed in the Southern District of Florida and, in November 1983, it was transferred to the Southern District of New York. In July 1985, after we reversed a grant of summary judgment in favor of the defendants, *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F2d 230 (2d Cir.1985), Gary Plastic moved for class certification.

On February 10, 1988, Judge Haight denied this motion and, pursuant to DR 5-102(A) of New York's Code of Professional Responsibility, disqualified Bailey & Dawes from pursuing Gary Plastic's individual claims. *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 119 F.R.D. 344(S.D.N.Y.1988).

Judge Haight scheduled a pre-trial conference for April 22, 1988. Gary Plastic failed to appear at this

conference, whereupon Judge Haight informed its local counsel of his continuing obligations and scheduled another conference for June 17, 1988. Plaintiff's local counsel appeared at this conference and applied for leave to withdraw. Also on June 17, 1988, Gary Plastic moved to reargue the certification and disqualification issues.

By order dated June 22, 1988, Judge Haight rejected the motion to reargue as untimely, relieved local counsel, and dismissed Gary Plastic's individual claims, with prejudice, for failure to prosecute. This order, however, gave Gary Plastic thirty days to find acceptable counsel and to move to vacate the order of dismissal. Three months elapsed, and on September 23, 1988, noting that Gary Plastic had not applied to have the action re-opened, Judge Haight directed that judgment be entered. This appeal followed and initially raises questions of appealability.

II.

[1] The denial of a class certification motion and the disqualification of counsel are interlocutory orders which are not immediately appealable under 28 U.S.C. § 1291. *See Coopers & Lybrand v. Livesay*, 437 U.S. 463, 98 S.Ct.2454, 57 L.Ed.2d 351 (1978) (class certification); *Richardson-Merrell Inc. v. Koller*, 472 U.S. 424, 105 S.Ct. 2757, 86 L.Ed.2d 340 (1985) (disqualification of counsel); *cf. Deposit Guar. Nat'l Bank v. Roper*, 445 U.S. 326, 336, 100 S.Ct. 1166, 1173, 63 L.Ed.2d 427 (1980) (denial of class certification appealable after entry of final judgment). Appellees assert that since Gary Plastic could not appeal the denial of its class certification motion directly, it should not be permitted to obtain appellate review by refusing to prosecute its individual claims.

In *Coopers & Lybrand*, the Court rejected the "death knell" doctrine which had treated as final, for purposes of 28 U.S.C. § 1291, orders denying class certification which, as a practical matter, made it unlikely that the disappointed class representative would pursue its individual claims. 437 U.S. at 469-77, 98 S.Ct. at 2458-62. In so holding, the Court identified several flaws relating to the "death knell" doctrine: (1) the impropriety of courts, as opposed to the legislature, formulating an appealability rule which turns upon the value of the plaintiff's individual claim, *id.* at 472-73, 98 S.Ct. at 2459-60; (2) the potential waste of judicial resources involved in determining whether the denial of class certification was, in fact, the "death knell" of the action, *id.* at 473-74, 98 S.Ct. at 2460-61; (3) the discretion which the doctrine accorded to district judges, *id.* at 474-75, 98 S.Ct. at 2460-61; (4) the fact that the doctrine operates only to the advantage of plaintiffs, *id.* at 476, 98 S.Ct. at 2462; and (5) the intrusion of appellate courts in the trial process, *id.*

In *Huey v. Teledyne, Inc.*, 608 F.2d 1234 (9th Cir.1979), relied upon by appellees, the district court declined to certify a class and subsequently dismissed the individual claims when the putative class representative refused to proceed. The Ninth Circuit held that a putative class representative may not evade the policy against piecemeal review by waiving his individual claims: "[w]here the record shows that the denial of class certification caused the failure to prosecute, that ruling does not merge in the final judgment for purposes of appellate review . . ." *Id.* at 1240; *accord Bowe v. First of Denver Mortgate Investors,*

613 F.2d 798 (10th Cir.), *cert. denied,* 447 U.S. 906, 1000 S.Ct. 2989, 64 L.Ed.2d 855 (1980); *cf. Sere v. Board of Trustees,* 852 F.2d 285, 288 (7th Cir.1988) (interlocutory order does not merge into final judgment where merger would reward party for bad faith and dilatory tactics).

By contrast, in *Allied Air Freight, Inc. v. Pan American World Airways, Inc.,* 393 F.2d 441 (2d Cir.), *cert. denied,* 393 U.S. 846, 89 S.Ct. 131, 21 L.Ed.2d 117 (1968), the district court had stayed an action until the plaintiff exhausted its administrative remedies. When the plaintiff refused to pursue these remedies, the court dismissed the action. While the appellant did not deny that it had intentionally defaulted in order to obtain review of the interlocutory order staying the action, this court held that the stay was reviewable since all interlocutory orders merge into a final order. *Id.* at 444; *cf. Drake v. Southwestern Bell Tel. Co.,* 553 F.2d 1185, 1186-87 (8th Cir.1977). Significantly, we expressly rejected the argument that permitting an appeal through this mechanism "would encourage all would-be appellants from interlocutory orders to do nothing [and] procure a dismissal . . . which could then be appealed." *Allied Air Freight,* 393 F.2d at 444.

We decline to follow *Huey* and *Bowe* and we reject appellees' assertion that *Allied Air* is no longer valid in light of *Coopers & Lybrand.* We note that the concerns identified by the Court in *Coopers & Lybrand, supra* at 179, are inapplicable where, as here, the putative class representative's individual claims have been dismissed for failure to prosecute. Moreover, since immediate appellate review will only be available to disappointed class representatives who risk forfeiting their

potentially meritorious individual claims, 7B C. Wright, A. Miller & M. Kane, *Federal Practice and Procedure* § 1802 at 483 (2d ed. 1986), reviewing the merits of the class certification order will not substantially undermine the policy against piecemeal review.

Thus, we hold that for purposes of appellate review, an order denying a motion for class certification merges into a final judgment which results from the class representative's failure to prosecute its individual claim. *Cf. Nichols v. Mobile Bd. of Realtors, Inc.*, 675 F.2d 671, 675 (5th Cir. Unit B 1982) (stating that Fifth Circuit has *sub silentio* refused to follow *Huey* and *Bowe*).

III.

In evaluating whether class certification is appropriate, the district court is required to consider the factors set forth in Rule 23, Fed.R.Civ.P. In light of the importance of the class action device in securities fraud suits, these factors are to be construed liberally. *Green v. Wolf Corp.*, 406 F.2d 291, 295, 298 (2d Cir.1968), *cert. denied*, 395 U.S. 977, 89 S.Ct. 3131, 23 L.Ed.2d 766 (1969).

In the present case, Judge Haight found that Gary Plastic was an inappropriate class representative since its claim is subject to several unique defenses including its continued purchases of CDs through Merrill despite having notice of, and having investigated, the alleged fraud.

[2] While it is settled that the mere existence of individualized factal questions with respect to the class representative's claim will not bar class certification, *see*,

e.g., Green, 406 F.2d at 301; *Dura-Bilt Corp. v. Chase Manhattan Corp.*, 89 F.R.D. 87, 98-99(S.D.N.Y.1981), class certification is inappropriate where a putative class representative is subject to unique defenses which threaten to become the focus of the litigation, *see, e.g., Kline v. Wolf*, 88 F.R.D. 696, 700(S.D.N.Y.1981) (Weinfeld, J.), *aff'd in relevant part*, 702 F.2d 400, 403 (2d Cir.1983); *J.H. Cohn & Co. v. American Appraisal Assoc. Inc.*, 628 F.2d 994, 998-99 (7th Cir.1980). Regardless of whether the issue is framed in terms of the typicality of the representative's claims, Rule 23(a)(3), Fed.R.Civ.P., or the adequacy of its representation, Rule 23(a)(4), Fed.R.Civ.P., there is a danger that absent class members will suffer if their representative is preoccupied with defenses unique to it. 7A C. Wright, A. Miller & M. Kane, *Federal Practice & Procedure* § 1764, at 259-60 (2d ed.1986) (typicality); 3B J. Moore & J. Kennedy, *Moore's Federal Practice* ¶ 23.07[1], at 23-192 (2d ed. 1987) (adequacy of representation).

[3] While the fact that Gary Plastic was the only plaintiff to come forward and seek to represent the class weighs in favor of certification, *see Green*, 406 F.2d at 298; *Dura-Bilt*, 89 F.R.D. at 101, a class "may only be certified if the trial court is satisfied, after a rigorous analysis, that the prerequisites of Rule 23(a) have been satisfied," *General Tel. Co. v. Falcon*, 457 U.S. 147, 161, 102 S.Ct. 2364, 2372, 72 L.Ed.2d 740 (1982). In the factual context presented, we see no abuse of discretion in the district court's refusal to certify a class action.

We need not consider whether the district court erred either in disqualifying Bailey & Dawes or in dismissing Gary Plastic's individual claim with prejudice since, at

oral argument, Gary Plastic conceded that it does not intend to pursue its individual claims.

IV.

The judgment of the district court is affirmed. Each party shall bear its own costs.

IN THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

No. 83 Civ. 9112 (CSH)

GARY PLASTIC PACKAGING CORP.,
a New York Corporation, for itself and others similarly situated,

Plaintiffs,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH, INC. and MERRILL LYNCH MONEY MARKETS, INC.,

Defendants.

119 F.R.D. 344

February 23, 1988

MEMORANDUM OPINION AND ORDER

HAIGHT, District Judge:

This federal securities fraud case is before the Court for class certification.

Plaintiff purchased from defendants a number of $100,000 negotiable and insured certificates of deposit (CDs) issued by certain banks and savings institutions. Plaintiff is a New York business corporation. Defendant Merrill Lynch, Pierce, Fenner and Smith, Inc. is a full

service financial and brokerage corporation. Defendant Merrill Lynch Money Markets, Inc. is a wholly owned subsidiary. The defendants will be collectively referred to as "Merrill Lynch."

Plaintiff's amended complaint alleges omission of material facts from an information bulletin Merrill Lynch issued to describe the investment program in suit. Plaintiff asks to be certified under Rule 23, F.R.Civ.P., as representative of a class consisting of "all purchasers of CDs from Merrill Lynch during the period May, 1982 to the present time."

Plaintiff filed its original complaint in the United States District Court for the Southern District of Florida. That court transferred the case here sua sponte. Judge Brieant (as he then was) granted summary judgment dismissing the complaint and refused plaintiff leave to replead. [1984] Fed.Sec.L.Rep. (CCH) para. 91, 490 (S.D.N.Y. 1984). The Second Circuit reversed, 756 F.2d 230 (2d Cir. 1985), holding that the CDs in question constituted "securities" within the ambit of the federal statutes, and that the amended complaint stated a viable securities fraud claim. Extensive discovery then took place. Plaintiff now moves for class certification. Defendants resist.

I.

The factual background appears in the cited opinions, familiarity with which is assumed. For present purposes it is sufficient to say that in September, 1980 defendant Merrill Lynch Money Markets, Inc. issued an "Information Bulletin" (hereinafter the "September 1980 Bulletin" or "Bulletin") describing a $100,000 CD

program. Executives at defendants' head offices sent the Bulletin to their account executives in Merrill Lynch field offices. Unlike an earlier written description of the program Merrill Lynch issued in July 1980 for internal use only, the September 1980 Bulletin was available both to Merrill Lynch account executives and, through them, to the investing public.[1] The Court of Appeals, after quoting the September 1980 Bulletin in its entirety, held that that document's alleged failure to disclose the nature and extent of Merrill Lynch's compensation on program transactions might state a federal securities fraud claim. "Commissions that defendants receive on the CDs they sell to the public are relevant and must be disclosed." 756 F.2d at 242.

However, discovery has revealed that plaintiff did not see the Bulletin and did not rely on it in deciding to purchase CDs from defendants. The following facts and circumstances now emerge.

Plaintiff Gary Plastic Packaging Corp. (hereinafter "Gary Plastic") is a New York corporation closely held by a family named Schur. There are four shareholders: Marilyn Schur Hellinger; her brothers Kenneth and Robert Schur; and Gary Hellinger, husband of Marilyn. Gary and Marilyn each own 25% of the shares of Gary Plastics, Kenneth owns 35%, and Robert 15%. Gary, Marilyn and Kenneth are the present directors. Until 1984 Robert was also a director. Gary is president. Robert is general counsel, vice-president, and assistant secretary.

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[1]Deposition of Emanuel Falzon at Tr. 208-209; deposition of Donald Caccipaglia at Tr. 70-72.

Robert is also a partner in the Miami firm of Bailey and Dawes, selected by Gary Plastic as class counsel.

Another family member is Howard Schur, first cousin of Marilyn, Kenneth and Robert, and nephew of Joseph Schur, father of Marilyn, Kenneth and Robert, and director and majority shareholder of Gary Plastic until 1984. Howard is a stockbroker whose career has led to employment at a number of brokerage houses, including at the pertinent times Merrill Lynch. Whenever Howard changed brokerages, the Schur family and Gary Plastic accounts went with him.

During May, June and July 1982 Gary Plastic bought twelve short term[2] (30, 60 or 90 day) $100,000 CDs from Merrill Lynch through Howard Schur. Each purchase was made as a result of oral representations made by Howard Schur to Hellinger. Hellinger never saw the bulletin. Nor did he see advertisemnets Merrill Lynch ran in newspapers describing its $100,000 CD program. Hellinger relied solely on what Howard Schur told him. So did Robert Schur when, in July 1982 he bought a 30-day $100,000 CD from Merrill Lynch through Howard Schur. Howard Schur received comissions on these sales.

A few days before July 28, 1982, Hellinger received an unsolicited telphone call from one Peter Thomas. Thomas worked at State Savings and Loan Association ("State"), an issuer of some of the CDs that Gary Plastic had purchased from Merrill Lynch. Thomas offered to

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[2]The particulars of each CD (issuer, maturities, and interest rate) are listed by the Court of Appeals at 756 F.2d 234 n.2.

Hellinger a CD at an interest rate "about one and a half or two percent higher" than the rate Gary Plastic had received from Merrill Lynch on earlier CDs.[3] That differential Hellinger testified, made him "very, very upset." He discussed the matter with his wife and brother-in-law Robert and asked Robert to look into the matter.[4]

On July 28, 1982 Gary Plastic purchased through Thomas directly a State 41 day $100,000 CD. Robert Schur bought a 60 day $100,000 CD from State on August 2 when his CD purchased through Merrill Lynch matured.

However, twice in August and twice in October, 1982, when CDs issued by other banks and purchased by Gary Plastic from Merrill Lynch matured, Gary Plastic bought four new CDs from those issuers through its Merrill Lynch account, for which Howard Schur was the representative. Hellinger has testified at his deposition that he did not know of those purchases at the time; but the testimony of the company bookkeeper, Muriel Kaye, would clearly support a contrary inference.

Between September 1982 and December 1983, Gary Plastic bought seven more $100,000 CDs directly through Thomas. Robert Schur bought a CD through Thomas in October 1982.

Howard Schur, who had joined Merrill Lynch in 1978, transferred to another brokerage in 1983.

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[3]Hellinger deposition at Tr.221.
[4]Id. at 141, 173.

At a Schur family meeting during Passover 1983, the Gary Plastics directors decided to commence this action. Robert Schur recommended and Gary Plastic accepted that Guy B. Bailey, Jr., Esq., Robert's partner at Bailey & Dawes, be retained as counsel, together with the firm. Mr. Bailey is not an experienced class action attorney.[5] The firm presently consists of eight partners and two associates.[6] The firm's fee arrangement contemplates Robert Schur's participation in a contingent fee, with each Bailey & Dawes partner working on the case (including Robert Schur) receiving double his or her hourly rate, and if the court awards greater than that, then it would be shared equally.[7]

II.

In these circumstances, defendants challenge class certification and representation on the grounds of lack of commonality, typicality and adequacy, factors complicated in defendants' view by issues arising from the canons of professional ethics.

Preliminarily it is useful to narrow the focus. Gary Plastic asks to represent a class consisting of all purchasers from Merrill Lynch of any CDs of any denomination, under any program, from May 1982 to the present. Disregarding any other problems, this is far too broad. Plaintiff complains of losses suffered as the result of its participation in a particular program, described by a particular document plaintiff says is fraudulent. The depositions show Merrill Lynch offered

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[5]Mr. Bailey candidly acknowledged at oral argument that he had been involved in only one prior class action involving a shoe company whose name he could not recall; his involvement "didn't last very long." Tr.13-14.

[6]Source: Martindale-Hubbell (1987).

[7]Deposition of Robert Schur at Tr.153-155.

a variety of CD investment vehicles to a variety of investors. Given plaintiff's emphasis on the $100,000 program described in the September 1980 Bulletin, as reflected by the Second Circuit's opinion, any class plaintiff might properly represent would be limited to purchasers of CDs from Merrill Lynch under that program.

Turning to that program, defendants' first objection is that in making their purchases Hellinger and Robert Schur relied solely on the oral representations of Howard Schur. That is true. It is also generally true that class treatment is denied in securities fraud cases where it is claimed that purchases were fraudulently induced by the oral representations of individual brokers or advisors. *See, e.g., In re Scientific Control Corp. Securities Litigation,* 71 F.R.D. 491, 500 (S.D.N.Y.1976).

But plaintiff advances a particular theory in the case at bar. The case for plaintiff is that defendants' material omissions from the September 1980 Bulletin, drafted by head office executives, misled both its account executives in the field and investors with whom they dealt. Assuming arguendo that the Bulletin failed to disclose defendants' compensation in violation of the securities laws, field brokers and customers alike were misled. This is the theory stressed by plaintiff's counsel at oral argument.[8] And there is authority for the proposition that where "a single written document is alleged to be materially false and misleading, the common questions predominate over those affecting only individual class members." *Frielander v. Barnes,* 104 F.R.D. 417, 419 (S.D.N.Y. 1984), *citing Korn v. Franchard Corp.,* 456 F.2d

[8] "That omission which was kept from its own account executives was the predominant thing." Argument of counsel at Tr.6.

1206, 1212 (2dCir.1972). *See also Kennedy v. Tallant,* 710 F.2d 711, 717 (11th Cir. 1983) (where defendants commit "the same unlawful acts in the same method against the entire class," all class members "have identical claims," and the "degree of reliance placed on the prospectuses by the various class members is not a controlling element"); *Green v. Wolf Corp.,* 405 F.2d 291, 299 (2d Cir.1968), *cert. denied,* 395 U.S. 977 (1969).

While the question is close, I conclude that given plaintiff's fraud theory, its sole reliance upon the oral representations of Howard Schur is not fatal to concepts of commonality or typicality.

III.

Where this class action fails is in the adequacy of the class representative and the inappropriate selection of its counsel.

I have concluded that Hellinger's and Robert Schur's reliance on Howard Schur's oral representations do not, standing alone, preclude certification. But substantial questions remain.

In the case at bar, a closely held family corporation purchased securities through a family member broker. Those purchases continued even after the corporation's officers and directors learned about the alleged fraud of which plaintiff now complains. During the pertinent times, a family member (Robert Schur) played the several roles of corporate director, officer, and shareholder, individual securities purchaser, and attorney investigating the circumstances of the alleged fraud. That individual's law firm was ultimately

retained as plaintiff's counsel and purported class counsel, with that particular family member expecting to be compensated at twice his regular hourly rate (or possibly more) from any proceeds of the litigation.

To recite these facts is to identify a number of significant problems.

First, Gary Plastic is subject to a unique defense on the issue of reliance. Hellinger has testified that when he received Thomas's unsolicited telephone call and learned of the interest rate differential, he was very upset. That sense of outrage, plaintiff says, eventually triggered this suit. Plaintiff's theory is that it relied on the Bulletin's falsely created impression (conveyed to brokers like Howard Schur, although not to Hellinger) that the interest rates paid to purchasers coincided with the interest rates paid by the issuing banks. But Gary Plastic purchased four more $100,000 CDs from Merrill Lynch after the revelatory Thomas telephone call and Hellinger's consequent outrage.

To be sure, Hellinger now says that he did not know that the closely held corporation of which he was president had entered into these transactions. No view need be expressed on the ultimate resolution of that issue to say that it is bound to be hotly contested. For if the finders of the fact conclude that Gary Plastic knowingly continued to purchase CDs from Merrill Lynch (and to the benefit of Howard Schur) after the Thomas conversation, the elements of materiality and reliance, crucial in any fraud case, are undermined.

There is ample authority in this circuit for rejecting

as class representative a claimant subject to unique defenses. *Kline v. Wolf,* 88 F.R.D. 696 (S.D.N.Y. 1981) (Weinfeld, J.), *aff'd,* 702 F.2d 400 (2d Cir. 1983); *Kraus v. Patterson Parchment Paper Co.,* 65 F.R.D. 368 (S.D.N.Y. 1974). The rationale was stated by the Seventh Circuit in *Koos v. First National Bank of Peoria,* 496 F.2d 1162, 1164 (7th Cir. 1974): "Where it is predictable that a major focus of litigation will be an arguable defense unique to the named plaintiff, then the named plaintiff is not a proper representative." In the case at bar, the defense of lack of materiality, lack of reliance, waiver and estoppel clearly arise out of Gary Plastic's course of conduct. These are precisely the concerns which Judge Weinfeld expressed in *Kline v. Wolf, supra,* at 700, and are fully applicable at bar:

> In sum, the unique defenses to which each plaintiff is subject, could become, as they already have, the focus of the litigation and upon a trial, divert attention from the substance of the basic claim. The remaining members of the class could be severely damaged by plaintiffs' representation of them. The respective claims of plaintiffs that their purchases of Allied stock were in reliance upon the integrity of the market and the Allied financial statement are subject to just such a challenge as to render their claims atypical of those of other members of the class. (footnote omitted).

I have also noted that a family relationship existed between the Merrill Lynch broker on plaintiff's account (Howard Schur) and the officers controlling plaintiff. Family relationship between a plaintiff and investor

and the individual broker is also regarded as grounds for qualifying the investor as a class representative. *Shankroff v. Advest, Inc.*, 112 F.R.D. 190, 194 (S.D.N.Y. 1986).

I do not raise that particular circumstance to the level of a per se rule. However, the Second Circuit said in *Kline v. Wolf, supra,* at 702 F.2d 403 that a "class representative is fiduciary, and interests of the class are 'dependent upon his diligence, wisdom and integrity'", citing and quoting *Cohen v. Beneficial Industrial Loan Corp.*, 337 U.S. 541, 549-50 (1949). The family relationship at bar furnishes a significant increment to the unique defense factor which I have discussed previously.

Secondly, Gary Plastic's choice of the Bailey & Dawes firm of which Robert Schur is a partner is inappropriate under the code of Professional Responsibility as enacted in New York State.

Disciplinary Rule 5-102(A) provides, with exceptions not here applicable:

> If, after undertaking employment in contemplated or pending litigation, a lawyer learns or it is obvious that he or a lawyer in his firm ought to be called as a witness on behalf of his client, he shall withdraw from the conduct of the trial and his firm, if any, shall not continue representation in the trial . . . N.Y.Jud.LawApp. (McKinney 1975).

The question of whether a lawyer "ought" to be

called as a witness on behalf of his client is an objective one for the trial judge. Neither litigants nor counsel can avoid the code by waiver or subjective disclaimer. *United States v. Cunningham*, 672 F.2d 1064, 1074 (2d Cir. 1982)

At Hellinger's direction Robert Schur conducted the post-Thomas telephone call investigation, including discussions with Howard Schur. To rebut the inference of non-reliance arising out of Gary Plastic's four subsequent CD purchases from Merrill Lynch, Robert Schur is an obvious and objectively necessary witness. In discovery plaintiff has resisted inquiry into Robert Schur's activities, under the work product rule and attorney-client privilege. But these protestations are doubtful at best. They focus solely upon Robert Schur's role as an attorney. In fact, however, he played several additional roles: those of corporate shareholder, director, and officer. As Judge Weinfeld said, disqualifying counsel in comparable circumstances:

> Moreover, Mr. Harris is not an individual litigator; the corporation of which he is a major shareholder is the plaintiff. Neither Mr. Harris's stock ownership, nor his status as an officer, grants the corporation an individual right to select its own counsel when such selection is clearly contrary to the Code of Professional Responsibility.

Acme Analgesics Ltd. v. Lemmon Co., 602 F.Supp 306, 307 (S.D.N.Y. 1985).

These circumstances suffice to distinguish the case at bar from *Bottaro v. Hatton Associates*, 680 F.2d 895

(2d Cir.1982), upon which plaintiff principally relies on the disqualification issue. The attorney in Bottaro was no more than an individual investor in the limited partnership venture which gave rise to the securities fraud action.

Conclusion

In the circumstances of this case I conclude that Gary Plastic cannot be certified as a class representative; and that the firm of Bailey & Dawes must be disqualified from further litigation pressing Gary Plastic's claims against the Merrill Lynch defendants.

Accordingly plaintiff's motion for class certification is denied. Bailey & Dawes will be disqualified. I make no order with respect to plaintiff's local counsel.

Defendants are directed to settle an order consistent with this Opinion on seven (7) days notice.

It is SO ORDERED.

IN THE UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

GARY PLASTIC PACKAGING CORPORATION,
a New York Corporation, for itself and
all others similarly situated,

Plaintiff–Appellant,

v.

MERRILL LYNCH, PIERCE, FENNER
& SMITH, INC., et.al.

Defendants–Appellees.

Dockets 84-7541, 84-7671

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756 F.2d 230 February 21, 1985

Before: NEWMAN, CARDAMONE and DAVIS, Circuit Judges.

CARDAMONE, Circuit Judge:

On this appeal we must determine whether a program devised by defendants Merrill Lynch, Pierce, Fenner & Smith, Inc. (Merrill Lynch) and its wholly-owned subsidiary, Merrill Lynch Money Markets, Inc. (Money Markets), to sell bank certificates of deposit (CDs) is within the compass of the federal securities law. In *Marine Bank v. Weaver,* 455 U.S. 551, 102 S.Ct. 1220, 1221, 71 L.Ed.2d 409 (1982), the Supreme Court held

that a conventional CD purchased from an issuing bank is not a security under the antifraud provisions of the federal securities laws. Nonetheless, the court stated that each transaction must be analyzed on the content of the particular instrument involved and the factual setting as a whole. The possibility that in certain circumstances a CD might be a security within the scope of the federal securities laws was specifically left open. *Id.* at 560 n. 11, 102 S.Ct. at 1225 n. 11.

The complaint alleges that defendants publish the Money Market Information Bulletin, which tells prospective customers that Merrill Lynch has available negotiable, insured, and liquid $100,000 CDs, for which they will maintain a secondary market. Defendants advertise that they screen daily a large group of quality banks to provide their customers with CDs with "competitive" yields from a variety of issuers. They represent that they will monitor the creditworthiness of issuing banks on a regular basis, and they discourage potential customers from seeking to deal directly with those banks. If the allegations of plaintiff's amended complaint are true, this sales message might be characterized as artful, but certainly not candid.

Plaintiff, who purchased 12 of the $100,000 CDs, claims that these certificates are not those regularly available at the issuing banks. Instead, plaintiff asserts that these CDs are specially created, issued and sold only to Merrill Lynch customers. Most significantly, plaintiff alleges that the rates of interest on the Merrill Lynch CDs were lower than the rates paid by the banks on their ordinarily issued CDs and that defendants pocketed the difference between the rates as an

undisclosed commission. From the gold that flows through a broker's hands, a small shaving may be taken as commission. Yet, credibility and confidence in the market may demand that the amount of this shaving be revealed to investors. At this early stage of the litigation, before any discovery, it is difficult to discern if there is merit to plaintiff's claims against these defendants. It is sufficient to say that in our view plaintiff's complaint states a cause of action and should not have been dismissed on defendants' motion for summary judgment.

I

Plaintiff Gary Plastic Packaging Corporation (Gary Plastic) brought this action in the United States District Court for the Southern District of Florida, for itself and for all others similarly situated, against defendants Merrill Lynch and Money Markets. The action was transferred, pursuant to 28 U.S.C. § 1404(a), to the Southern District of New York (Brieant, J.) in December 1983. The complaint contains four counts that alleged violations of §§ 5(a) and 17 of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934, and the SEC's Rule 10b-5. One count alleges a civil RICO violation, 18 U.S.C. § 1962(c). All allegations stem from the same transactions between Gary Plastic and Merrill Lynch. In its Money Market Information Bulletin, Merrill Lynch described its CD Program, involving bank certificates of deposit[1] issued by both commercial and savings and loan institutions (referred to as banks) as

[1] As defined in federal regulations,

[t]he term "time certificate of deposit; means a deposit evidenced by a negotiable or nonnegotiable instrument which provides on its face that the amount of such deposit is payable to bearer or to any specified person or to his order:

Footnote continued on next page

follows:

> ***FULLY INSURED $100,000 NEGOTIABLE CERTIFICATES OF DEPOSIT***
>
> **Merrill Lynch Money Markets Inc. (MLMMI) is offering its customers a unique opportunity to purchase $100,000 *negotiable* certificates of deposit that are fully *insured* and *liquid.***
>
> ***INSURANCE COVERAGE***
>
> **This opportunity, for individuals or corporate investors with $100,000 or more to invest, has been made possible as a result of recent changes in Federal Deposit Insurance Corporation (FDIC) and Federal Savings and Loan Insurance Corporation (FSLIC) regulations dealing with deposit insurance coverage. In essence, both the FDIC and FSLIC have raised their deposit insurance coverage to $100,000 from $40,000 per depositor per institution.**

(Footnote continued from previous page)

(1) On a certain date, specified in the instrument, not less than 30 days after the date of the deposit, or

(2) At the expiration of a certain specified time not less than 30 days after the date of the instrument, or

(3) Upon notice in writing which is actually required to be given not less than 30 days before the date of repayment, and,

(4) In all cases only upon presentation and surrender of the instrument. 12 C.F.R. § 217.1(c) (1951).

A certificate of deposit is a receipt for the deposit of funds in a bank of which there are two classes, demand and time. Demand certificates of deposit are payable on demand, and time certificates of deposit are payable on a specified date, or so many days after date, upon proper indorsement. These time certificates are similar to savings deposits, but have a definite maturity, and are evidenced by a certificate instead of a passbook entry. Time certificates of deposit may bear interest, and are, therefore, a convenient means of investing temporarily idle funds, which otherwise would be unemployed.

G. MUNN. ENCYCLOPEDIA OF BANKING OF FINANCE 178-79 (F.L. Garcia rev. ed. 1973).

SIGNIFICANCE

The extended coverage will enable an investor to purchase a $100,000 certificate of deposit from an FDIC or FSLIC insured commercial bank or savings and loan association and have the total principal amount of the investment covered by Federal deposit insurance. Carrying this a step further, one could distribute investible funds in $100,000 increments among a number of banks to ensure Federal deposit insurance coverage of the total amount. Investors can now purchase $100,000 negotiable certificates of deposit and enjoy the benefits of having their entire deposit insured by a Federal agency and at the same time take advantage of the exemption from interest rate ceilings that Regulation Q provides for certificates of deposit that are $100,000 or larger.

A NEW OPPORTUNITY

MLMMI will provide its investors with an opportunity to take advantage of this regulatory change by offering, on a daily basis, a broad selection of fully insured $100,000 certificates of deposit issued by domestic commercial banks and savings and loan associations in a range of maturities. Each of the issuers whose certificates of deposit are offered has been reviewed and approved by the MLPF & S Corporate Credit Department and is monitored on a regular basis. Credit reports that provide an historical analysis of each issuer will be readily available through your MLPF & S Account Executive.

LIQUIDITY

The $100,000 certificates of deposit that MLMMI is offering enjoy a high degree of liquidity since they are in negotiable bearer form and are fully insured by a Federal agency. In addition, MLMMI fully intends to maintain a secondary market for its customers which would enable them to sell their certificates of deposit back to MLMMI at prevailing market rates without the significant interest rate penalties Federal banking regulations require banks to impose on the early redemption of their certificates of deposit.

ALTERNATIVES

The more popular alternatives would include *Treasury Bills, Federal Agency Securities* and *Money Market Funds.* With the increase in deposit insurance coverage, an investor now has the opportunity to purchase Federally insured certificates of deposit, an investment which usually carries higher yields than Treasury Bills and Federal Agency Securities. While money market funds do enjoy liquidity, they are not federally insured and cannot guarantee a future rate of return.

WHY MLMMI

Some investors may seek to purchase $100,000 certificates of deposit directly from a bank or savings and loan association. However, they can only call a few local banks at most, their alternatives are critically limited. You have no

way of knowing if the banks you are calling are in the market trying to raise money at a competitive rate or if they are quoting a rate just to accommodate a depositor. Our specialized bank liability trading staff talks to a large group of pre-screened, quality banks daily before offering certificates of deposit to investors enabling MLMMI to provide the investor with certificates of deposit with competitive yields from a variety of issuers. The interest rate penalties for early redemption imposed under Federal Banking regulations do not apply to certificates of deposit sold back to MLMMI. They do apply if you redeem your certificates of deposit prior to maturity at the issuing bank. MLMMI intends to maintain a secondary market in these negotiable bearer certificates of deposit for its customers providing them with a source of liquidity at prevailing market rates. In addition to the safety factor of having Federal insurance for these deposits, the highly professional MLPF & S Corporate Credit Department is monitoring, on a regular basis, those issuers whose certificates of deposit MLMMI offers and will provide a written credit analysis on each. For additional information on this new program, contact your local Merrill Lynch Account Executive.

MERRILL LYNCH MONEY MARKETS, INC.

When, in 1982, plaintiff ordered 12 CDs from Merrill

Lynch,[2] Money Markets contacted financial institutions in various parts of the country, and purchased the CDs. For each certificate of deposit purchased, Gary Plastic received an order ticket and a confirmation slip from Merrill Lynch. The actual CDs were held by the "delivery agent," Manufacturers Hanover Trust company, and when they matured, Gary Plastic received all principal and interest due it under the terms of the confirmation slips.

On May 20, 1983, plaintiff brought this action. The gravamen of the complaint was that the interest rates shown on the customer confirmation slips were lower than the interest rates actually paid by the banks according to the terms of the deposit certificates. The complaint further asserted that while defendants in the Money Market Information Bulletin purported to perform its services free of charge, they actually retained the difference between the rate shown on the confirmation slip and the actual certificate of deposit rate as an "excessive, undisclosed commission." Plaintiff further charged that the Bulletin omitted and

Trade Date	*Issuer*	*Amount*	*Rate*	*Maturity*
5/20/82	Imperial Bank of Los Angeles	$100,000	13.70%	6/21
5/20/82	Home Savings & Loan	100,000	13.80%	6/21
5/20/82	Northern California Savings & Loan	100,000	13.80%	6/21
5/20/82	Pacific First Federal Savings & Loan	100,000	13.80%	6/21
5/25/82	World Savings & Loan	100,000	13.35%	6/25
5/28/82	Imperial Savings & Loan	100,000	13.35%	6/25
6/18/82	Northern California Savings	100,000	14.50%	7/21
6/18/82	State Savings Stockton, CA	100,000	14.50%	7/21
6/24/82	Sumitoma Bank of California	100,000	14.60%	8/24
6/24/82	World Savings & Loan	100,000	14.60%	8/24
6/30/82	Great Western Savings	100,000	14.50%	8/2
7/20/82	Imperial Savings & Loan	100,000	12.55%	10/19

misrepresented material facts in violation of the antifraud provisions of the 1933 and 1934 Acts and that in violation of § 5(a) of the 1933 Act, defendants sold the CDs when no registration statement was in effect.

On April 17, 1984 plaintiff's counsel met informally with Merrill Lynch employees and, for the first time, learned how Merrill Lynch operated its CD Program. Although the information plaintiff obtained during that meeting was far from complete, plaintiff realized that some of the factual assumptions upon which its complaint was based were incorrect. The complaint's premise that the confirmation slips and the certificates of deposit stated different rates of interest was inaccurate. In its proposed and amended complaint plaintiff has set forth the facts that came to light during the meeting. Essentially, Merill Lynch determines on a given day the lowest interest rate it can market (the "competitive" rate) and has its subsidiary Money Markets purchase CDs in bulk from various banks at that rate. The banks specially create these CDs for Money Markets and Merrill Lynch markets them to its customers. Money Markets pays a commission to Merrill Lynch for the sale. Merrill Lynch furnishes its customer with a confirmation slip indicating that it acted as agent on its customer's behalf.

Plaintiff claims that the wrong in all of this is that Merrill Lynch never informed customers that the issuing bank was actually paying on its regularly issued CDs a rate of interest higher than the rate set on the instruments created for and marketed by Merrill Lynch. For example, plaintiff introduced evidence that Pacific Federal offered 15% interest to customers who purchased CDs directly from it, as compared to the 13.8% interest

paid plaintiff on the CD it bought through Merrill Lynch. Similarly, State Savings Stockton was offering 16.1%, while plaintiff received only 14.5%, and Northern California Savings was offering 14.75%, while plaintiff earned only 13.8%. Money Markets collects the difference between the rates a bank agrees to pay on its regular CDs and the lesser amount it pays on CDs marketed by Merrill Lynch. Thus, plaintiff claims Merrill Lynch pooled funds and used its market power not to obtain the best rates available that day for its customers, as its literature implied, but instead to advance its own economic advantage.

Just one week after their informal meeting in April 1984, the parties appeared at a hearing before the district judge. Plaintiff told the court that it had new information on the operation of the CD Program and that the program's operation was based on a "factual pattern" that was "slightly different from that that [plaintiff] had envisioned" when drafting the complaint 11 months earlier. On April 30 defendants submitted portions of the confirmation slips and an affidavit explaining that the rates stated on the confirmation slips matched the rates on the certificates of deposit. Defendants' documents confirmed what plaintiffs had already conceded, that the origianl complaint was based upon an incorrect factual predicate.

Fifteen days later, before plaintiff had submitted answering papers, the district court granted summary judgment to defendants. The court concluded that the complaint was based on unfounded allegations and that the transaction did not involve a "security" within the meaning of the 1933 and 1934 Acts. [Current] Fed.Sec.L.

Rep. (CCH) ¶ 91,490 (S.D.N.Y. May 15, 1984). In July plaintiff moved to set aside the judgment under Fed. R.Civ.P. 59(e) or 60(b), and to amend its complaint under Rule 15. Plaintiff's proposed amended complaint alleged the same four counts as its initial complaint, but was based on the information plaintiff had obtained one week prior to the April 24 hearing. The court denied the Rule 59(e) motion because it was untimely. *See* Fed.R.Civ.P. 59(e) ("A motion to alter or amend the judgment shall be served not later than 10 days after entry of the judgment"). The Rule 60 motion was also denied because plaintiff did not present "newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial under Rule 59(b)." Fed.R.Civ.P. 60(b)(2).

Plaintiff appeals, urging that the district court's grant of summary judgment and refusal to grant leave to amend the complaint was an abuse of discretion, that the certificates of deposit sold through the CD Program were "securities" under the federal securities laws, and that its amended complaint states a viable claim for securities fraud. We reverse the judgment below and remand the case to the district court for further proceedings on the merits.

II

Plaintiff argues that the district court improperly granted defendants' motion for summary judgment under Fed.R.Civ.P. 56. Plaintiff asks that we reverse that order and remand with leave to amend the complaint under Fed.R.Civ.P. 15. We conclude that it was an abuse of the trial court's discretion to grant summary judgment when plaintiff had moved to amend its

complaint and had not conducted discovery in this complex securities matter.

[1, 2] While summary judgment is a valuable procedural device for promptly disposing of actions in which there is no genuine issue as to any material fact, it is also a drastic remedy that cuts off the right to have one's day in court. *Heyman v. Commerce and Industry Insurance Co.*, 524 F.2d 1317, 1320 (2d Cir.1975). The harshness of the remedy is exacerbated when the trial court refuses to allow plaintiff to conduct discovery. Discovery serves important purposes, such as avoiding surprise, fully disclosing the nature and scope of the controversy, narrowing, simplifying, and framing the issues involved, and enabling parties to obtain the factual information needed to prepare for trial. 8 C. Wright & Miller, *Federal Practice and Procedure* ¶ 2001 (1970). Rules governing disovery should be interpreted broadly to achieve those purposes. *See, e.g., Schlesinger Investment Partnership v. Fluor Corp.*, 671 F.2d 739, 742 (2d Cir.1982) ("The federal rules evince a liberal policy with regard to discovery in order to allow litigants to secure helpful evidence from the hands of their adversaries"). It follows that summary judgment should be sparingly granted in securities fraud cases when discovery is incomplete and under circumstances where, as here, defendants have exclusive possession of the material facts. *See Schlesinger Investment Partnership*, 671 F.2d at 743; *George C. Frey Ready-Mixed Concrete, Inc. v. Pine Hill Concrete Mix Corp.*, 554 F.2d 551, 555 (2d Cir.1977); *Schoenbaum v. Firstbrook*, 405 F.2d 215, 218 (2d cir.1968) (in banc), *cert. denied*, 395 U.S. 906, 89 S.Ct. 1747, 23, L.Ed.2d 219 (1969). Rather, in the preliminary stages of the lawsuit, the trial court should

permit discovery and freely grant leave to amend the complaint under Rule 15. Fed.R.Civ.P. 15(a) ("leave [to amend] shall be freely given when justice so requires"). *See Foman v. Davis*, 371 U.S. 178, 181, 83 S.Ct. 227, 229, 9 L.Ed.2d 222 (1962); *Goldberg v Meridor*, 567 F.2d 209, 213 (2d Cir.1977), *cert. denied*, 434 U.S. 1069, 98 S.Ct. 1249, 55 L.Ed.2d 771 (1978) ("the undesirability of granting summary judgment to defendants in a stockholder's derivative suit before discovery has been completed . . . dictate[s] liberality in allowing such complaints to be amended to reflect facts already discovered").

In dismissing the complaint, the trial court concluded that the factual predicate of the complaint—that the interest rates stated on the confirmation slips were less than the interest rates stated on the certificates of deposit—was not correct. Merrill Lynch's unrefuted evidence showed that the interest rates stated on the certificates of deposit purchased by Gary Plastic were identical to the rates shown on the corresponding confirmations. Plaintiff had learned at the April 17 meeting that this factual predicate was incorrect. Instead of continuing to argue plaintiff's initial position, counsel informed the district court that new facts had come to light and sought leave to amend the complaint.

Dismissal of the case at that point, without further opportunity to conduct discovery, was an abuse of discretion. With the exception of one informal meeting and a few incomplete "audit trail" documents, plaintiff has not obtained information from a single Merrill Lynch officer or bank officer. Thus, it has been forced to proceed without knowledge of many material facts.

For example, plaintiff has yet to learn important details of the operations of the CD Program, such as the precise amount and derivation of the commissions Merrill Lynch received, the specific roles played by Merrill Lynch and its subsidiaries, and the exact nature of the dealings between Merrill Lynch and the various banking institutitons. That the district judge had some knowledge of plaintiff's inability to obtain information is clear from the fact that he ordered Merrill Lynch to file confirmation slips and other documentary evidence of the transactions with its customers. To resolve this dispute, Merrill Lynch's relationship with its customers and the banks should be further explored. Plaintiff should have the opportunity to incorporate its newly obtained facts into its amended complaint to correct the factual predicate of its original complaint.

III

In its amended complaint plaintiff will charge that defendants have violated Sections 5(a) and 17 of the 1933 Act, 15 U.S.C. §§ 77e(a), 77q, and Section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), and SEC Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5 (1984). Section 5 of the 1933 Act prohibits the sale of a "security" unless a registration statement is in effect. Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act are the antifraud provisions of the securities acts, prohibiting the use of any scheme to obtain money by means of an untrue statement or omission to state a material fact or of any manipulative or deceptive device in connection with the purchase or sale of any "security." Hence, as a threshold matter, in the application of both federal acts, plaintiff must show that the transactions involved a "security." Plaintiff argues

that the CDs sold through the CD Program are "securities" within the meaning of the Acts. We undertake now to resolve that important issue.

A. *Background of Securities Acts*

In 1933 and 1934, in the wake of the 1929 stock market crash, Congress enacted a comprehensive regulatory scheme to eliminate abuses in the nation's financial markets. The two Acts passed in those years were designed to provide investors with material information and to protect the investing public from the sale of worthless securities through misrepresentation. H.R.Rep. No. 85, 73d Cong., 1st Sess. 1-5 (1933); *United Housing Foundation, Inc. v. Forman,* 421 U.S. 837, 849, 95 S.Ct. 2051, 2059, 44 L.Ed.2d 621 (1975); *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 195, 96 S.Ct. 1375, 1382, 47 L. Ed.2d 668 (1976). The legislation was intended to encourage "honest dealing in securities and thereby bring back public confidence" in the investment markets and to eliminate the "unethical and unsafe practices of bank and corporate officers." Letter from President Franklin D. Roosevelt to Congress (March 29, 1933), *reprinted in* 77 Cong.Rec. 937 (1933). As part of the regulatory reformation, Congress enacted the Banking (Glass-Steagall) Act of 1933, 12 U.S.C. §§ 227 *et seq.,* which separated investment banking and deposit banking. The Glass-Steagall Act created the Federal Deposit Insurance Corporation (FDIC) to insure bank depositors against loss and created a thorough plan that regulated virtually all aspects of deposit banking institutions. The financial transactions at issue, which involve both an invesment marketing firm and instruments issued by banking institutions must be analyzed in light of this regulatory design.

B. *Definitions of "Security" Under the Acts*

The securities acts define "security" in Section 2(1)[3] of the 1933 At, 15 U.S.C. § 77b(1), and Section 3(a)(10)[4] of the 1934 Act, 15 U.S.C. § 78c(a)(10). Although the precise working of the two definitional sections differs, the Supreme Court has consistently held that the definitions are virtually identical and the coverage of the two Acts may be considered the same. *See Marine*

[3] When used in this subchapter, unless the context otherwise requires—
(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

[4] When used in this chapter, unless the context otherwise requires—
(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foreging, but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

Bank, 455 U.S. at 555 n. 3, 102 S.Ct. at 1223 n. 3; *United Housing Foundation*, 421 U.S. at 847 n. 12, 95 S.Ct. at 2058 n. 12; *Tcherepnin v. Knight*, 389 U.S. 332, 342, 88 S.Ct. 548, 556, 19 L.Ed.2d 564 (1967). The definitions of "security" are broad and ambiguous; they allow courts to use a flexible approach "to meet the countless and variable schemes devised by those who seek the use of money of others on the promise of profits." *SEC v. W.J. Howey Co.*, 328 U.S. 293, 299, 66 S.Ct. 1100, 1103, 90 L. Ed. 1244 (1946); *see United Housing Foundation*, 421 U.S. at 847-48, 95 S.Ct. at 2057-59 (Congress "sought to define 'the term security in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security.'") (quoting H.R.Rep. No. 85, 73d Cong., 1st Sess. 11 (1933)). Although courts should construe the statutes broadly, because they are remedial, they should keep in mind that to afford the securities laws too wide a reach over banking institutions could overburden that already extensively regulated industry.

Numerous tests have been applied to determine whether various instruments described as "notes" or "stock" fall within the scope of the definition, such as the "economic reality" test, *see W.J. Howey Co.*, 328 U.S. at 299, 66 S.Ct. at 1103, the "commercial/investment" test, *see McClure v. First National Bank*, 497 F.2d 490, 493 (5th Cir.1974), and the "risk capital" test, *Landreth Timber Co. v. Landreth*, 731, F.2d 1348, 1352 (9th Cir.1984). Our circuit stands alone in applying a more literal approach, *see Exchange National Bank v. Touche Ross & Co.*, 544 F.2d 1126, 1137-38 (2d Cir.1976); *Seagrave Corp. v. Vista Resources, Inc.*, 696 F.2d 227, 229

(2d cir.1982). We need not address the continued applicability of these tests because in *Marine Bank* the Supreme Court applied the definition of security to facts so similar to those in the present case that we are bound by its reasoning to the exclusion of criteria articulated in other contexts. *See Wolf v. Banco Nacional de Mexico, S.A.*, 739 F.2d 1458, 1461 (9th Cir.1984), *cert. denied*, — U.S. —, 104 S.ct. 784, 83 L.Ed.2d 778 (1985) (court relied on *Marine Bank* criteria to find that Certificate of Deposit issued by a Mexican bank was not a security).

Of the several types of instruments defined as securities, the financial instruments here most closely resemble "investment contracts." The Supreme Court first interpreted the definition of "investment contract" in *SEC v. C.M. Joiner Leasing Corp.*, 320 U.S. 344, 64 S.Ct. 120, 88 L.Ed. 88 (1943). *See* Note, *The Definition of Security: Marine Bank v. Weaver*, 24 *B.C.L.Rev.* 1053 (1983) (overview of the Supreme Court's decisions defining investment contract). *Joiner* involved a widely circulated offer to sell assignments of oil leases. In holding that the contracts to sell those lease assignments were investment contracts, the Court focused on whether they were "widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a "security."'" 320 U.S. at 351, 64 S.Ct. at 124. The Court stated that the test is "what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect." *Id.* at 352-53, 64 S.Ct. at 124-25 (*quoted in Marine Bank*, 455 U.S. at 556, 102 S.Ct. at 1223). *See Glen-Arden Commodities, Inc. v. Costantino*, 493 F.2d

1027 (2d Cir.1974) (where defendants sold whisky warehouse receipts, and stored, insured, marketed, and sold the whisky for the purchasers, the whisky warehouse receipts were found to be "investment contracts").

In *W.J. Howey Co.*, the Supreme Court narrowed the *Joiner* "character in commerce" test, stating specific requirements that continue to be the analytical foundation for determining what constitutes an investment contract. In that case defendants sold acreage in its citrus grove under a contract pursuant to which a W.J. Howey Co. subsidiary cultivated, harvested, and marketed the citrus crops. The Court held that the contracts were investment contracts within the meaning of the 1933 Act. The *Howey* Court stated: "[A]n investment contract . . . means a contract, transaction or scheme whereby a person [1] invests his money [2] in a common enterprise and [3] is led to expect profits [4] solely from the efforts of the promotor or a third party . . ." 328 U.S. at 298-99, 66 S.Ct. at 1102-03.

In *Marine Bank v. Weaver*, the Supreme Court added a further limiting requirement to the *Howey* test: for an instrument to be a security the investor must risk loss. The Court held that a conventional certificate of deposit was not a security under the federal securities acts because federal banking regulations and the FDIC eliminate all risk of loss to the investor. The court below concluded that the CDs in this case are not different from those in *Marine Bank* and that neither the CDs nor the CD Program is a security under federal law. We disagree.

In *Marine Bank* plaintiffs purchased a $50,000 six-year certificate of deposit from defendant Marine Bank, a federally regulated Pennsylvania bank. Plaintiffs pledged the CD to Marine Bank to guarantee a loan made by the bank to Columbus Packing Co. In consideration for guaranteeing the loan, the Weavers contracted with the owners of Columbus to receive $100 per month, 50% of Columbus' net profits, and the use of a barn and pasture. They also were given the right to veto future borrowing by Columbus. When Columbus failed and the bank prepared to claim the CD, plaintiffs sued the bank, alleging, *inter alia*, that the bank had violated the antifraud provisions of the 1934 Act, 15 U.S.C. § 78j(b). Plaintiffs claimed that the bank had told them that Columbus would use the loan as working capital, but instead the loan was immediately applied by the bank against Columbus' overdue obligations. 455 U.S. at 553. The Supreme Court rejected the Third Circuit's conclusion that this certificate of deposit is similar to any other long-term debt obligation commonly found to be a security and held that the CD was not a security. In a footnote the court added the following caveat:

> It does not follow that a certificate of deposit . . . invariably falls outside the definition of a "security" as defined by the federal statutes. Each transaction must be analyzed and evaluated on the basis of the content of the instruments in question, the purposes intended to be served, and the factual setting as a whole.

Id. at 560 n. 11, 102 S.Ct. at 1225 n. 11. The crux of the *Marine Bank* decision is that federal banking

regulations and federal deposit insurance eliminate the risk of loss to the investor, thereby obviating the need for the protection of the federal securities laws. *Id.* at 558-59, 102 S.Ct. at 1224-25. In addition, the Court held that the private agreement between plaintiffs and the owners of Columbus, negotiated one-on-one, was not a security because of its unique character and highly personal terms. The CDs issued by Merrill Lynch present an entirely different picture.

C. *The CDs Sold Through the CD Program are "Securities" under the Howey Test and Marine Bank*

[3] In the present case, the certificates of deposit sold through the CD Program satisfy the *Howey* test for determining what constitutes an investment contract within the meaning of the Acts. Gary Plastic invested $1,200,000 in its CD purchases. By investigating issuers, marketing the CDs, and creating a secondary market, Merrill Lynch was engaged in a common enterprise within the meaning of *Howey*. Finally, investors such as Gary Plastic expect profits derived solely from the efforts of Merrill Lynch and the banks. Plaintiff's investment in the CD Program was motivated by the expectation of a return of cash investment, the potential for price appreciation due to interest rate fluctuations, and the liquidity of these highly negotiable instruments.

Merrill Lynch is engaged in activity that is significantly greater than that of an ordinary broker or sales agent. Since Merrill Lynch possesses significant economic power, it is able to negotiate with the issuing banks to obtain a favorable rate of interest. Pursuant to defendants' scheme, the banks create new CDs that

carry interest rates lower than those they pay their direct customers. From this differential, Merrill Lynch receives a commission for its services, which include providing a secondary market and cultivating a large group of banks that desire to borrow money. Therefore, a significant portion of the customer's investment depends on Merrill Lynch's managerial and financial expertise.

The customers rely on the skill and financial stability of Merrill Lynch for a number of reasons. First, resale in the secondary market created and maintained by Merrill Lynch is crucial to the investor. If, for example, Merrill Lynch were to become insolvent and investors were unable to sell their CDs in the secondary market, they would lose two significant advantages; liquidity and capital appreciation. Ordinary CDs purchased directly from the issuing bank are not freely redeemable prior to maturity. Those redeemed before maturity are subject to a substantial withdrawal penalty. Thus, these CDs sold through the CD Program afford the investor a high degree of liquidity that it would not otherwise have. More importantly, by purchasing through the CD Program the investor has the option of selling its CD back to Merrill Lynch if prevailing interest rates drop, thereby realizing profits from capital appreciation. In the event Merrill Lynch failed to maintain the promised secondary market, an investor would have considerable difficulty liquidating a CD.

Second, the investor relies on Merrill Lynch's implicit promise to maintain its marketing efforts. The success of the secondary market and the availability of

CDs at competitive rates hinge on Merrill Lynch's success in finding new buyers of CDs and developing strong working relationships with issuing banks. If Merrill Lynch were not an influential and well-known participant in the marketplace, the CD Program would not be viable.

Finally, investors rely on Merrill Lynch's ongoing monitoring of the issuing banks. If an issuing bank becomes insolvent, the FDIC or FSLIC will pay the investor the principal due under the terms of the certificate of deposit.[5] Here investors are buying something more than an individual certificate of deposit. they are buying an opportunity to participate in the CD Program and its secondary market. And, they are paying for the security of knowing that they may liquidate at a moment's notice free from concern as to loss of income or capital, while awaiting for FDIC or FSLIC insurance proceeds.

Plaintiff's decision to invest is obviously made in reliance upon the efforts, knowledge and skill of Merrill Lynch. This is a significant factor that sets this case apart from *Marine Bank*. At the outset *Marine Bank* acknowledges that it is dealing with a "conventional certificate of deposit," 455 U.S. at 552, 102 S.Ct. at 1221. In the present case, defendant's executive vice-president is alleged to have characterized the CD created and sold through the CD Program as *wholy different* from an ordinary certificate of deposit. The Weavers dealt with

[5] We note that two of the CDs purchased by plaintiffs apparently had a face value above $100,000—$10,000 in one instance and $2,000 in the other. Federal insurance is unavailable for amounts above $100,000 in the event of insolvency.

the issuing bank. As a result, the FDIC protected them fully against any risk of loss due to the insolvency of the bank from which they expected to derive their profits. The CD Program investor relies not only on the future solvency of the issuing bank, but also on the future solvency of Merrill Lynch to enjoy the unique benefits of this investment opportunity. The federal banking laws, including the FDIC, do not eliminate the risk to the CD Program investor. These investors are not "abundantly protected" under the federal banking laws. Like the holder of an ordinary long-term debt obligation, the CD Program investor assumes the risk of insolvency of defendants as unregulated borrowers. Unlike *Marine Bank*, federal securities fraud protection in this case is not a double-coating. Rather, absent the securities laws, plaintiff has no federal protection against fraud and misrepresentation by the defendants in the marketplace.

Further, the CD Program is not excluded from being a security by the uniqueness restriction of *Marine Bank*. It contains no unique terms such as the veto power over future borrowing or use of a barn and pasture contained in the agreement in *Marine Bank*. It is not a one-of-a-kind arrangement. Instead the CDs sold through the CD Program are offered to the public at large, travel through the public markets and have the equivalent value to most persons. Hence, the uniqueness restriction found in *Marine Bank* is not present here.

The result we reach is consonant with the comprehensive financial regulatory plan enacted by Congress in 1933 and 1934. The Glass-Steagall Act separated large private banks, whose chief business was investment, from deposit banks. *See* 77 Cong.Rec. 3730

(1933). *See generally* Note, *Bank Certificate of Deposit; Notes not in Tune with Securities Regulation,* 10 *Fordham Urban L.J.* 469, 476-77 (1982). The CDs sold through the CD Program represent essentially a joint effort between the issuer of the CD, the deposit bank, and Merrill Lynch as the market maker, the investment bank. Investors put their money and confidence in the financial and managerial expertise of both institutions. They receive returns from both: interest payments from the deposit bank and services such as credit checks and negotiability from the investment bank. The banking laws protect investors from the abuses and misrepreentations of the former. The securities acts regulate the latter.

In *Marine Bank,* the reason for exempting certificates of deposit from the securities acts was to eliminate double coverage when the Glass-Steagall Act and the securities acts overlap. Were we to find the CDs sold through this CD Program not to be covered by the federal securities laws, a gap would exist in the regulatory scheme that would strip the investor of needed federal protection. The "content of the instruments in question, the purposes intended to be served, and the factual setting as a whole" make this an appropriate case for finding these instruments to be within the definitions of "security." *See Marine Bank,* 455 U.S. at 560 n. 11, 102 S.Ct. at 1225 n. 11. *See also* H.R. No. 626(I), 97th Cong., 2d Sess. 9-10, *reprinted in* 1982 U.S.Code Cong. & Ad.News 2780, 2788 (*Marine Bank* left "open the question of whether a certificate of deposit could be a security in another context"). Therefore, we hold that the certificates of deposit issued and sold pursuant to defendant Merrill Lynch's CD

Program are "securities" for purposes of the antifraud provisions of both Acts.

IV.

Once amended, plaintiff's complaint will state a triable claim. *See McLain v. Real Estate Board of New Orleans, Inc.*, 444 U.S. 232, 246, 100 S.Ct. 503, 511, 62 L.Ed.2d 441 (1980). There should be further proceedings to determine whether Merrill Lynch's Information Bulletin is deceptive because of its alleged failure to disclose material issues of fact required under the federal securities acts. *See, e.g., Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741 (1972) (defendants' failure under particular facts to state that they were market makers was a violation of Rule 10b-5); *Glen-Arden Commodities*, 493 F.2d at 1032 (affirming a preliminary injunction against defendants engaged in a whisky warehouse receipt brokerage scheme based, among other things, on defendants' failure to inform its customers that they were charging prices considerably in excess of the prices charged by other brokers). We express no opinion as to whether defendants' acts actually violated the antifraud provisions of the securities laws, as that is the issue that must be decided by the trial court.

Plaintiff should also have a chance to prove that the CDs it purchased did not yield the "competitive" (some would read this as "best available") interest rates promised by the Information Bulletin. In the Information Bulletin, Merrill Lynch plainly holds itself out as agent for its customer. The confirmation slip sent to its customers states that Merrill Lynch "made this transaction as your agent." Yet, at the April 24 hearing

Merrill Lynch's counsel stated that one of its subsidiaries "acts as the agent for the issuing institution." An affidavit of the executive vice-president of Money Markets confirms that Money Markets acts as agent for issuing institutions and was paid commissions by them. These circumstances might lead an investor to believe that Merrill Lynch served at the same time as agent for two masters. Because banks and investors like plaintiff have different objectives respecting CD interest rates, an agent for both will tend to prefer one over the other.

[4] Commissions that defendants receive on the CDs they sell to the public are relevant and must be disclosed. It is not clear from the record the extent of defendant's commissions, although several are mentioned. For example, in addition to the interest it earned on the flow of funds through its hands, Merrill Lynch received commissions at the end of each month from issuing banks for the funds placed with it. It also may have received all or a portion of the differential in the interest rate the bank would have paid on a given day and the claimed lesser amount the bank paid on CDs created for defendants. Plaintiff argues that if this is the case, then it was actually paying Merrill Lynch an undislosed commission.[6]

[6] We do not address plaintiff's claim under § 5(a) of the 1933 Act. 15 U.S.C. § 77e(a). On remand, the district court should determine the Act's registration requirements on the CDs sold through the CD Program and the applicability of any exemptions from registration. *See* 15 U.S.C. § 77c(a)(2), (a)(5). *See also* SEC No Action Letter, *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 14 Sec.Reg. & L.Rep. (BNA) No. 46, at 2053-54 (Nov. 26, 1982); *Management Corp. of America*, 14 Sec.Reg. & L.Rep. (BNA) No. 16 (April 23, 1982). Nor do we address the RICO claim alleged in plaintiff's complaint. The district court will have further opportunity to rule upon this claim in light of existing law when this matter is again before it.

Accordingly, the judgment of the district court is reversed and the case is remanded with directions to reinstate the complaint, as amended, and for further proceedings consistent with this Opinion.

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Filed July 24, 1990

At a stated term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 24th day of July, one thousand nine hundred and ninety.

GARY PLASTIC PACKAGING CORPORATION

Plaintiff-Appellant,

v.

MERRILL LYNCH, PIERCE, FENNER & SMITH INCORPORATED and MERRILL LYNCH MONEY MARKET, INC.,

Defendants-Appellees.

DOCKET NUMBER 89-7295

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by

Appellant GARY PLASTIC PACKAGING CORPORATION

Upon consideration by the panel that heard the appeal, it is Ordered that said petition for rehearing is DENIED.

It is further noted that the suggestion for rehearing in banc has been transmitted to the judges of the court in regular active service and to any other judge that heard the appeal and that no such judge has requested that a vote be taken thereon.

ELAINE B. GOLDSMITH
Clerk

STATUTES INVOLVED

Title 15 — United States Code

§ 77e. Prohibitions relating to interstate commerce and the mails.

Sale or delivery after sale of unregistered securities

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly —

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

Necessity of prospectus meeting requirements of section 77j of this title

(b) It shall be unlawful for any person, directly or indirectly —

(1) to make use of any means or instruments of transportation or communication in interstate

commerce or of the mails to carry or transmit any prospectus relating to any security with respect tow hich a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (1) of section 77j of this title.

Necessity of filing registration statement

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

June 6, 1934, c. 404, Title I, § 10, 48 Stat. 891.

§ 77q. Fraudulent interstate transactions

Use of interstate commerce for purpose of fraud or deceit

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in

order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Use of interstate commerce for purpose of offering for sale

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

Exemption for section 77c not applicable to this section

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

§ 1962. Prohibited activities.

(a) It shall be unlawful for any person who has received any income derived, directly or indirectly, from a pattern of racketeering activity or through collection of an unlawful debt in which such person has participated as a principal within the meaning of section 2, title 18, United States Code, to use or invest, directly or indirectly, any part of such income, or the proceeds of such income, in acquisition of any interest in, or the establishment or operation of, any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce. A purchase of securities on the open market for purposes of investment, and without the intention of controlling or participating in the control of the issuer, or of assisting another to do so, shall not be unlawful under this subsection if the securities of the issuer held by the purchaser, the members of his immediate family, and his or their accomplices in any pattern or racketeering activity or the collection of an unlawful debt after such purchase do not amount in the aggregate to one percent of the outstanding secucrities of any one class, and do not confer, either in law or in fact, the power to elect one or more directors of the issuer.

(b) It shall be unlawful for any person through a pattern of racketeering activity or through collection of an unlawful debt to acquire or maintain, directly or indirectly, any interest in or control of any enterprise which is engaged in, or the activities of which affect, interstate or foreign commerce.

(c) It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity or collection of unlawful debt.

(d) It shall be unlawful for any person to conspire to violate any of the provisions of subsections (a), (b), or (c) of this section.

Federal Rules of Civil Procedure

Rule 23. Class Actions

(a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with

respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

(c) Determination by Order Whether Class Action to be Maintained; Notice; Judgment; Actions Conducted Partially as Class Actions.

(1) As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order under this subdivision may be conditional, and may be altered or amended before the decision on the merits.

(2) In any class action maintained under subdivision (b)(3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that (A) the court will exclude him from the class if he so requests by a specified date; (B) the judgment, whether favorable or not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if the member desires, enter an appearance through counsel.

(3) The judgment in an action maintained as a class action under subdivision (b)(1) or (b)(2), whether or not favorable to the class, shall include and describe those whom the court finds to be members of the class. The judgment in an action maintained as a class action under subdivision (b)(3), whether or not favorable to the class, shall include and specify or describe those to whom the notice provided in subdivision (c)(2) was directed, and who have not requested exclusion, and whom the court finds to be members of the class.

(4) When appropriate (A) an action may be brought or maintained as a class action with respect to particular issues, or (B) a class may be divided into subclasses and

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each subclass treated as a class, and the provisions of this rule shall then be construed and applied accordingly.

(d) Orders in Conduct of Actions. In the conduct of actions to which this rule applies, the court may make appropriate orders: (1) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument; (2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representation fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action; (3) imposing conditions on the representative parties or on intervenors; (4) requiring that the pleadings be amended to eliminate therefrom allegations as to representation of absent persons, and that the action proceed accordingly; (5) dealing with similar procedural matters. The orders may be combined with an order under Rule 16, and may be altered or amended as may be desirable from time to time.

(e) Dismissal or Compromise. A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs.

IN THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA

GARY PLASTIC PACKAGING CORP.,
a New York corporation, for
itself and all others similarly situated,

Plaintiff,

v.

MERRILL LYNCH, PIERCE, FENNER
and SMITH, INC., a Delaware
Corporation, and MERRILL LYNCH
MONEY MARKETS, INC., a Delaware Corporation,

Defendants.

Excerpts from Deposition of
GARY PLASTIC PACKAGING CORP. by
GARY HELLINGER, *President*

AUGUST 1, 1985

BY MR. BRADLEY:

Q. Were there any certificates of deposit purchased by Gary Plastic through Howard Schur at Merrill Lynch, subsequent to the August 25, 1982 purchase of the Great Western CD?

MS. BUSTO: Let the record reflect that Mr. Hellinger is now looking at a statement for the period

ending October 29, 1982.

MR. HELLINGER:

A. There was a CD redeemed on October 19th and rolled over into a CD by Howard Schur into something that's into a CD called AMER SL829.9, 100,000, same amount.

Q. So on October 19, 1982, Gary Plastic bought a $100,000 CD of American Savings & Loan Association; is that not correct?

A. Yes.

Q. And this was done through Howard Schur at Merrill Lynch?

A. Yes.

Q. Howard Schur did not execute this transaction without the authorization of Gary Plastic, did he?

A. He executed it without my authorization.

Q. It is an unauthorized transaction?

A. No.

Q. It is an authorized transaction?

A. You asked if it was mine. I said no. But it is authorized in that the person —

Q. I am talking about Gary Plastic. Did Gary Plastic authorize the purchase of the $100,000 American Savings & Loan Association certificate of deposit through Howard Schur at Merrill Lynch on October 19, 1982?

MS. BUSTO: Object to the form of the question, in that the term Gary Plastic, you are not defining what you mean by did Gary Plastic authorize it.

Q. Do you have difficulty in understanding that question?

MS. BUSTO: Maybe if you would allow him to explain.

MR. BRADLEY: Are you instructing him not to answer that question?

MS. BUSTO: No, you are arguing with the witness.

BY MR. BRADLEY:

Q. Did Gary Plastic authorize the purchase of that certificate of deposit, to your knowledge, Mr. Hellinger?

A. To my knowledge is the answer it was not with my knowledge. It was not with my knowledge.

Q. Do you repudiate that transaction?

A. No.

Q. Do you know if at any time Gary Plastic has told Merrill Lynch that this transaction was not authorized or approved by appropriate people at Gary Plastic?

A. No.

Q. Was this transaction authorized and approved by appropriate people at Gary Plastic?

A. It was made by an appropriate person, but it was not in the sense authorized and approved.

Let me explain what happened.

Q. Who made the transaction?

MS. BUSTO: Would you please allow him to finish his answer?

MR. BRADLEY: Miss Busto, I am afraid this is my deposition. I am entitled to ask the questions I want to ask. You are entitled to cross examine.

I am not here to hear speeches by Mr. Hellinger or by you.

BY MR. BRADLEY:

Q. Now, who made the transaction? What is the name of the person?

A. Muriel Kay.

Q. What is her position?

A. She is my bookkeeper.

Q. Were you aware of this transaction at any time in the month of October 1982?

A. If it were brought to my attention, I don't recall.

Q. You don't recall whether or not you were aware of this transaction?

A. That's exactly right.

Q. Do you recall when you became aware of this transaction?

A. Yes.

Q. When?

A. When I looked for the records in answer to your subpoena for information.

Q. The first time you became aware of this transaction on October 19, 1982, in which Gary Plastic Corporation purchased a $100,000 certificate of deposit of American Savings & Loan through Howard Schur at Merrill Lynch was within the last month or two?

A. Yes.

Q. Would you advise me whether or not Gary Plastic

purchased any other certificates of deposit in the month of October 1982 through Howard Schur at Merrill Lynch?

A. There was one on October 25th. There was redeemed or rolled over.

There were – let's put it this way, after July there were certificates of deposit that were rolled over by Howard Schur receiving the authorization to roll over by my bookkeeper, Muriel Kay, and I was not aware of this until just recently, within the last month.

J.A. 430-434

IN THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA

GARY PLASTIC PACKAGING CORP.,
a New York corporation, for
itself and all others similarly situated,

Plaintiff,

v.

MERRILL LYNCH, PIERCE, FENNER
and SMITH, INC., a Delaware
Corporation, and MERRILL LYNCH
MONEY MARKETS, INC., a Delaware Corporation,

Defendants.

Excerpts from Deposition of MERRILL LYNCH
CAPITAL MARKETS by
DONALD C. CACCIAPAGLIA, *Vice President*

JUNE 14, 1985

Q. Was this two-page bulletin not an effort on behalf of Money Markets to solicit customers?

A. That's correct.

Q. It was not?

A. It is an information bulletin. It is not a sales brochure.

* * *

Q. Well, this bulletin is either for customers or account executives, isn't that true?

A. It is for account executives.

J.A. 891-892

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

GARY PLASTIC PACKAGING CORP.,

Plaintiff,

- against -

MERRILL LYNCH, PIERCE, FENNER and SMITH, INC., and MERRILL LYNCH MONEY MARKETS, INC.,

Defendants.

Excerpts from Continued Deposition of
EMANUEL J. FALZON

JULY 24, 1985

Q. Other than the July 1980 Money Market Information Bulletin, Exhibit 3 or the September 1980 Money Market Information Bulletin, Exhibit 1, was there any information given to account executives in the Merrill Lynch system concerning how the rate or rates on these $100,000 C.D.'s was determined?

MR. FALZON:

A. No. As far as the $100,000 program goes, we didn't say anything specifically about how the rates would be arrived at between the institutions and the

trading desk.

This is directed to the investors, I assume?

Q. Yes. Well, the same answer would apply to investors as well as account executives in that regard, you don't know of any way anybody would know how the rates were determined?

A. That's right, we never talked about that.

Q. It is true, is it not, that there was never any specific disclosure to A.E.'s or investors that your trading desk did not even inquire of participating banks or thrifts what those banks or thrifts were otherwise offering to pay for $100,000 C.D.'s on a given day?

MR. BRADLEY: Read that back, please?

(The question requested was read back by the reporter.)

MR. BRADLEY: Objection. You may answer.

MR. FALZON:

A. That is true.

Q. It is also true, is it not, that there was never any disclosure to A.E.'s or to investors in the $100,000 C.D. program what commissions Merrill Lynch was receiving from issuers?

A. Well, I don't know if we ever divulged that to account executives or not.

Q. Do you know of any instance where it was divulged to an account executive?

A. Not any specific instance, no.

Q. Have you ever seen any piece of paper that purported to disclose that, that being the commission to account executives generally?

A. This is the commission that we were earning on the C.D., buying it from the institution?

Q. Yes, sir.

A. No, I have never seen anything in writing reporting that.

J.A. 1333-1334

IN THE UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF FLORIDA

GARY PLASTIC PACKAGING CORP.,
a New York corporation, for itself
and all others similarly situated,

Plaintiff,

- against -

MERRILL LYNCH, PIERCE, FENNER and
SMITH, INC., a Delaware corporation,
and MERRILL LYNCH MONEY MARKETS, INC.,
a Delaware Corporation,

Defendants.

Excerpts from Deposition of
HOWARD SCHUR

JULY 25, 1985

Q. Did you use that, refer to that (1980 bulletin) or work from that document in making your sales presentations to the customers? Did you use the information contained in that document?

MR. SCHUR:

A. Not verbatim.

★ ★ ★

Q. Did you use the information contained in that document in your sales presentation?

A. The information, we would get a document like this and read it. We would have sales meetings, hammer it out to fine points.

The real world of selling this stuff is not to use a document like this. We don't have time. Brokers are too lazy to really go over everything like this, spend the whole morning reading this.

The assistant manager would give you the highlights, such as our specialized bank tradings, staff talks to a large group, prescribed quality bank daily before offering certificates of deposit to investors, enabling Merrill Lynch money market to provide investors with certificates of deposit with a competitive yield from a variety of issues.

★ ★ ★

But the assistant manager would give us the highlights, best yields, FDIC-insured, et cetera, et cetera, et cetera, and puts it on with this and sends it around to all of us.

★ ★ ★

Q. Did you make that document [1980 Bulletin] available to your customers?

A. No.

J.A. 1655-1658